S. Hrg. 98-481

CHURCH AUDIT PROCEDURES ACT

HEARING

BEFORE THE

SUBCOMMITTEE ON OVERSIGHT OF THE
INTERNAL REVENUE SERVICE

OF THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

NINETY-EIGHTH CONGRESS

FIRST SESSION

SEPTEMBER 30, 1983

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CHURCH AUDIT PROCEDURES ACT

FRIDAY, SEPTEMBER 30, 1983

U.S. SENATE,
SUBCOMMITTEE ON OVERSIGHT OF THE
INTERNAL REVENUE SERVICE,
COMMITTEE ON FINANCE,
Washington, D.C.

The committee met, pursuant to notice, at 9:47 a.m., in room SD-215, Dirksen Senate Office Building, Hon. Charles E. Grassley (chairman) presiding.

Present: Senator Grassley.

[The press release announcing the hearing follows:]

[Press Release]

For immediate release—August 29, 1983

FINANCE SUBCOMMITTEE ON OVERSIGHT OF THE INTERNAL REVENUE SERVICE SETS HEARING ON CHURCH AUDIT PROCEDURES ACT

Senator Charles E. Grassley (R., Iowa), Chairman of the Subcommittee on Oversight of the Internal Revenue Service of the Committee on Finance, announced today that the Subcommittee will hold a hearing at 9:30 a.m. on Friday, September 30, 1983, on S. 1262, the Church Audit Procedures Act of 1983.

In announcing the hearing, Senator Grassley noted that "the Subcommittee would like to hear testimony on current Internal Revenue Service church audit procedures to determine if additional safeguards may be necessary to preserve First Amendment freedoms of religious organization. When I introduced S. 1262, I intended to clarify and expedite Internal Revenue Service audits of religious organizations and minimize potential constitutional entanglements. I hope that the testimony the Subcommittee will hear will give us guidance on to what extent this legislation would be effective to further these goals and whether any modifications would be appropriate."

The hearing will begin at 9:30 a.m. in Room SD-215 of the Dirksen Senate Office Building.

STATEMENT OF SENATOR CHARLES E. GRASSLEY

I would like to call this meeting of the Subcommittee on Oversight of the Internal Revenue Service to order. The topic for today's hearing is the procedure employed by the I.R.S. to audit religious organizations. As a corollary to investigating current practice, I would like to focus on how the Church Audit Procedures Act might clarify current procedures and address some of the shortcomings in current church audit practice.

I became interested in church audit procedures under the Internal Revenue Code when I chaired hearings in this Subcommittee on the Taxpayer Protection and Reimbursement Act in 1981. That legislation contained a provision for reimbursement of attorney's fees to those who suffer government actions that are proven unsuccessful or baseless. At those hearings, testimony was presented by a witness representing an audited church whose congregation spent thousands of dollars and expended hundreds of man-hours during examinations by the I.R.S. The audit resulted in exoneration, but I was struck by how quickly the integrity, character, and moral foundations of small congregations could be undermined by innuendo, rumor, and press coverage during extended I.R.S. examinations. I became convinced that the problems touched upon in the testimony deserved serious investigation. The entire issue of auditing churches must be viewed from a Constitutional perspective. The First Amendment guarantees citizens the right to freely exercise their religious convictions and prevents Federal establishment of religion among our cherished First Amendment freedoms, freedom of religion is one of the most zealously protected. Our republic was founded by individuals who fled religious persecution, and risked their lives in a new and untamed land to freely practice thier religious beliefs.

Historically, there has been tension between the right of religious organizations to be free from governmental interference in their exercise of religion and the proper degree of power allowed the government to seek information from those organizations. Recognizing the sensitivity of government examination of religious organizations, some tax evaders have sought refuge in alleged religious organizations to avoid paying taxes. This misuse of religious form has increased the tension between the government and churches as the I.R.S. attempts to determine who is claiming to be a church for tax shelter purposes. This interface between church and state needs to be examined by Congress to be certain the First Amendment rights of churches are not trampled in the government's zeal to collect revenue.

Not only is it important to review the I.R.S.'s current church audit procedures to assess whether they pass constitutional muster, we must all look to the future to be certain sufficient safeguards exist to protect religious organizations. Under the guidance of Commissioner Egger and many of his predecessors, the I.R.S. has tried to exercise extreme caution in the audit of churches. Nevertheless, it is critical that we examine existing church audit procedures to be certain they adequately protect churches from capricious meddling by future I.R.S. personnel. We need to be rigorous in our analysis of I.R.S. practices to establish whether existing safeguards protect these important constitutional freedoms.

The Commissioner will outline current church audit procedures and critique the provisions of S. 1262. My bill, introduced by Congressman Mickey Edwards in the House, creates new pre-examination rights for churches. S. 1262 requires the I.R.S. to have evidence before commencing an examination, and it requires the Service to notify the taypayer in writing about the reasons for the audit, the information the I.R.S. hopes to discover, the specific code sections which are at issue and an explantion of the organization's rights. Before an examination is undertaken the Regional Counsel, as well as the Regional Commissioner, must approve the audit. Also, the I.R.S. must offer the taxpayer a conference to discuss the evidence obtained by the I.R.S. and the issues to be explored during the audit prior to sending a notice of intent to examine. These provisions are designed to apprise a church of the issues likely to be examined and flag any possible misunderstandings before a formal examination begins. It is the feeling of many members of the religious community that these pre-examination notices and meetings will assist both parties in clarifying misunderstandings and increasing co-operation among the parties.

My bill also requires the IRS to complete an audit within 365 days of its inception. This provision is crafted to require the IRS to be focused and expeditious in its inquiry to avoid unconstitutional entanglement. If a church initiates a judicial challenge or refuses to comply with the IRS's reasonable requests, the time limit is tolled.

Taxpayers who file returns may be audited for three prior years. Often tax-exempt taxpayers do not file returns, thus they have unlimited open years for audit and potential back tax liability. My bill limits a church's open audit years to three prior years to limit its tax liability. The bill also requires the IRS to assess the tax if the church has paid a portion of the liability before proceeding to court for collection. These provisions are designed to reduce a church's exposure for back taxes and provide them with every opportunity to pay the deficiency.

Last, this bill permits a church to proceed to court rather than exhaust its administrative remedies within the IRS when a church has been notified that its tax-exempt status is revoked or if the IRS intends to levy a tax on unrelated business income. While the IRS rarely favors sidestepping its administrative procedures, it seems that little would be gained by requiring churches to proceed through the administrative network when the regional commissioner and regional counsel are required to approve the examination at the outset.

I look forward to the comments of the witnesses on possible refinements to this legislation. My goal is to minimize any conflict between churches and the IRS when an audit is deemed to be necessary. If this hearing unearths factual dispute about the extent of the church audit problem, I will consider requesting the Joint Committee on Taxation to examine prior audited cases to resolve any dispute about the issues. Again, we cannot merely confine our inquiry to passed inequities. We must closely study our current procedures to be certain they adequately protect churches in the future when we may be unable to guarantee a responsible administration of the agency.

DESCRIPTION OF S. 1262 (CHURCH AUDIT PROCEDURES ACT OF 1983)

Scheduled for a Hearing

before the

SUBCOMMITTEE ON OVERSIGHT OF THE
INTERNAL REVENUE SERVICE

of the

COMMITTEE ON FINANCE

ON SEPTEMBER 30, 1983

Prepared by the Staff

of the

JOINT COMMITTEE ON TAXATION

INTRODUCTION

The Subcommittee on Oversight of the Internal Revenue Service of the Senate Committee on Finance has scheduled a public hearing on September 30, 1983, on S. 1262 (Church Audit Procedures Act of 1983), introduced by Senators Grassley, Helms, and East. The bill would provide additional rules relating to IRS procedures for investigating and auditing church books and records.

The first part of the pamphlet is a summary. The second part is a more detailed description of the bill, including present law, issues, explanation of provisions, and effective date.

I. SUMMARY

Present law imposes special restrictions on IRS examination of church records and activities. Under present law, the IRS may examine church books of account (except as indicated) (i.e., financial records) only for certain specified purposes, including the determination of tax-exempt status and the amount (if any) of unrelated business income. In addition, the IRS must provide special advance notice before examining church books of account. Present law also limits examination of church religious activities to the extent necessary to determine whether an organization actually is a church.

The bill would provide several further restrictions on IRS investigation and examination of church records and activities. Under the bill, the IRS would be allowed to investigate an organization claiming to be a church only if it possessed evidence which led it reasonably to believe (1) that the church actually is engaged in taxable activities, or (2) that the organization does not qualify for tax exemption. The IRS would also be required to provide expanded notice before examining church books and records, and to offer church officials an opportunity to meet with the IRS prior to any examination.

The bill would retain the present law restrictions on examination of church religious activities. However, under the bill, the IRS could examine church records of any kind (including books of account and other records) only to the extent necessary to a determination of tax liability. The bill also includes a number of special procedural provisions designed to expedite determinations of church tax liability.

II. DESCRIPTION OF THE BILL

A. Present Law

IRS authority to examine taxpayer records

IRS summons authority

The Internal Revenue Code provides the IRS with authority to examine taxpayer books and records for the purpose of assessing or collecting tax. In addition, the IRS may summon any individual to appear before a revenue agent to give testimony under oath or to produce books and records (Code sec. 7602).

The U.S. Supreme Court has held that, for a summons to be enforceable in a civil tax proceeding, the IRS must demonstrate (1) that the investigation will be conducted pursuant to a legitimate purpose, (2) that the material sought is relevant to this purpose, (3) that the information is not already possessed by the IRS, and (4) that the proper administrative procedures have been followed (*Powell* v. *Commissioner*, 379 U.S. 48 (1964)).

Conduct of examinations

Under present law, the IRS must conduct examinations of taxpayers, and their books and records, in a reasonable manner. The IRS is specifically prohibited from examining a taxpayer's books twice for the same tax year without notifying the taxpayer in writing that such additional examination is necessary (Sec. 7605(b)).

Restrictions on examination of churches

Churches, like other organizations organized and operated exclusively for religious, charitable, or educational purposes, are exempt from Federal income tax (sec. 501(c)(3)). However, exempt organizations, including churches, are subject to tax on income from the conduct of any trade or business which is not substantially related to the organization's exempt purpose (secs. 511-14).

Present law (sec. 7605(c)) imposes certain special restrictions upon IRS examination of churches for the purpose of determining whether a church may be engaged in activities which result in unrelated business taxable income, and for purposes of determining tax-exempt status. These include special restrictions concerning the extent of any examination of church books of account and the notice required to be given in advance of an examination. The law also provides further restrictions on the examination of church religious activities.

Church books of account

Notice requirement

The IRS is prohibited from examining the books of account[1] of a church (including conventions or associations of churches) unless (1) the IRS regional commissioner believes that such examination is necessary, and (2) the regional commissioner so notifies the organization in advance of the examination.

Treasury regulations provide that this notification must be made in writing at least 30 days in advance of the examination. The regulations provide further that the regional commissioner may conclude that an examination is necessary only after reasonable attempts have been made to obtain information by written request and the regional commissioner has determined that the information cannot be fully or satisfactorily obtained in that manner. Treas. Reg. sec. 301.7605-1(c)(2).

Treasury regulations state that the purposes of the restrictions upon examinations concerning unrelated business taxable income are to protect churches from undue interference in their internal financial affairs, and to limit the scope of the examination to matters directly relevant to the existence or amount of such income. Treas. Reg. sec. 301.7605-1(c)(1).

Scope of examination

Present law provides that the books of account of an organization that claims to be a church may be examined only to the extent necessary to determine the amount (if any) of tax. Under Treasury regulations, this may include examinations (1) to determine the initial or continuing qualification of the organization as a tax-exempt entity under section 501(c)(3); (2) to determine whether the organization qualifies to receive tax-deductible contributions; (3) to obtain information for the purpose of determining the tax liability of a recipient of payments (e.g., minister's salaries) from the organization; or (4) to determine the amount of tax, if any, which is to be imposed on the organization. The regulations provide further that, in any examination of a church for the purpose of determining liability for tax on unrelated business income, the church books of account may be examined only to the extent necessary to determine such liability.

In *United States* v. *Dykema*, 666 F.2d 1096, *cert. den.*, 102 S. Ct. 2257, *reh. den.*, 103 S. Ct. 17 (1982), the United States Court of Appeals for the Seventh Circuit held that the limitation to "necessary" examinations of churches applied only to investigations of unrelated business income. The case involved an IRS summons for various church books of account as part of an investigation of the church's tax-exempt status. The court held that the IRS could examine any records relevant and material to a determination of tax-exempt status.

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[1] The IRS has interpreted "books of account" to include accounting and bookkeeping records (including cash books, ledgers, etc.) kept in the regular course of business to provide detailed financial records. Under this interpretation, nonfinancial records (e.g, corporate minute books) and direct evidence of financial transactions (e.g., cancelled checks) may not be protected by the statute. See Internal Revenue Manual Part 7(10)71.22(1); *U.S.* v. *Grayson County State Bank*, 656 F.2d 1070 (5th Cir. 1981), *cert. den.*, 102 S.Ct. 968 (1982).

Religious activities

Present law provides that, when an organization claims to be a church, the religious activities of the organization may be examined only to the extent necessary to determine whether the organization actually is a church. Treasury regulations provide that this includes (1) a determination of the initial or continuing qualification of the organization as a tax-exempt entity; (2) a determination of whether the organization qualifies to receive tax-deductible contributions; and (3) a determination of whether the organization is subject to the provisions of the Code regarding unrelated business taxable income.

Once it has been determined that an organization is a church, no further examination of its religious activities may be made in connection with determining its liability for tax on unrelated business income. Treas. Reg. sec. 301.7605-1(c)(3).

The law does not require the regional commissioner of the IRS to give special notice before examining the religious activities of a church for the purposes described above. However, the IRS administratively had adopted such a procedure (Internal Revenue Manual Part 7(10)71.21(4)).

Statute of limitations

Under the general limitation provision of the Code (sec. 6501), the IRS is required to assess income taxes, or to initiate a proceeding for collection without assessment, within 3 years after the return was filed. Where a taxpayer fails to file a return, the 3-year limitation is inapplicable, and the tax may be assessed at any time. The tax may also be assessed at any time in the case of a false or fraudulent return, or a willful attempt to defeat or evade tax in any manner.

Declaratory judgment actions

Present law (sec. 7428) allows a taxpayer to bring a declaratory judgment action in any case involving a controversy (including an adverse IRS determination or failure to make a determination) with respect to tax-exempt status under section 501(c)(3). The action may be brought in the Tax Court, Claims Court or the United States District Court for the District of Columbia.

The court may issue a declaratory judgment only upon determining that the taxpayer has exhausted administrative remedies available within the IRS. An organization is deemed to have exhausted its administrative remedies if the IRS fails to make a determination within 270 days after the determination was requested and the organization has taken all timely and reasonable steps to secure a determination.

Prohibition of injunction suits

Present law generally prohibits taxpayers from seeking injunctions against assessment or collection of tax.

B. Issues

The principal issue is whether further limitations should be placed on IRS investigation and examination of church activities for the purpose of determining a church's tax-exempt status or the amount (if any) of unrelated business taxable income. Related issues include:

Should the IRS be required to make a special evidentiary determination before commencing an investigation of church activities?

Should the IRS be required to meet with church officials before examining church books and records?

Should any special provisions regarding churches be applicable to all investigations of church activities (including investigations concerning the tax-exempt status of a church), or only to investigations concerning unrelated business taxable income?

Should special notice be required only prior to examination of church books of account, or prior to examination of any church books and records?

Should the procedures for assessing tax against churches (including notice requirements, statute of limitations, and exhaustion of administrative remedies) differ from those with regard to other tax-exempt institutions?

C. Explanation of the Bill

Overview

The bill would allow the IRS to investigate an organization claiming to be a church only if it possessed evidence which led it reasonably to believe that the organization was engaged in taxable activities or did not qualify for tax exemption. The bill would also provide expanded notice requirements before examining any church books and records, including a requirement that church officials have an opportunity to meet with IRS representatives before an examination of church records. The bill would limit examinations of any church books and records to only those necessary to determine tax liability. In addition, the bill would add special procedural provisions designed to expedite the determination of church tax liabilities.

Restrictions on investigation of churches

The bill would prohibit an IRS regional commissioner from commencing any investigation or proceeding to determine whether a church (including a convention or association of churches) was engaged in taxable activities, or whether an organization qualified for tax exemption as a church under section 501(c)(3), unless the regional commissioner possesses evidence which leads him reasonably to believe (1) that the church is actually engaged in taxable activities, or (2) that the organization does not qualify for tax exemption.

Before commencing an investigation or proceeding for these purposes, the IRS would be required to provide written notice to the organization against which the investigation or proceeding is initiated. This notice would be required to include (1) a list of the Code provisions which authorize the investigation or proceeding; (2) an explanation of the rights of the organization under the Code and under the Constitution (including the right to be represented by legal counsel and the right to challenge any subpoena or other IRS process on legal or constitutional grounds); (3) an explanation of the concerns which gave rise to the investigation and of the relevant legal and factual issues; and (4) a description of all evidence discovered to date. Additionally, the notice would be required to include a specific and clearly worded statement of the facts the IRS "hopes to determine" by means of the investigation or proceeding.

Examination of church records and activities

Concurrence of regional counsel

Under the bill, the IRS could examine church records (including books of account and other records) or church religious activities, for the purpose of any investigation described above, only upon receiving the concurrence of the IRS regional counsel in the proposed examination.

Offer of conference

Prior to submitting a recommendation for examination to the regional counsel, the regional commissioner would be required to notify the organization whose records were to be examined, in writing, that an examination is under consideration. This notice would be required to include a list of the concerns which gave rise to the investigation, the relevant legal and factual issues, and a description of all evidence discovered to date.

The regional commissioner would further be required to offer the organization, in writing, an opportunity to meet with an IRS official to discuss the facts, evidence and issues relating to the investigation. The organization would have 15 days after notification in which to request such a meeting.

Notice of examination

After receiving the concurrence of the regional counsel in the proposed examination, the IRS would be required to notify the organization at least 15 days prior to the examination. This notification would be required to include a description of all church records and activities which the IRS seeks to examine.

Scope of examination

The bill would provide that church records (including books of account and other records) may be examined only to the extent necessary to a determination of tax liability.

The bill would retain the present law rule that the religious activities of any organization claiming to be a church may be examined only to the extent necessary to determine whether the organization actually is a church.

Requirement of IRS determination within one year

Under the bill, in any investigation or proceeding brought against a church, the IRS would be required to make a determination within 365 days after notifying the church of the commencement of the investigation. This period would not run during any judicial proceeding initiated by the church or during any period in which the IRS is unable to make a determination because of the refusal of the church to comply with reasonable requests for information.

Statute of limitations

The bill would require the IRS to to assess any tax against a church both (1) within 3 years after the tax became due, and (2) before the expiration of 3 years after the date on which any part of the tax was paid. The IRS would also be prohibited from bringing a court proceeding for collection without assessment after any part of the tax was paid, or more than 3 years after the tax was due. These limitations would apply regardless of whether the church filed a return for the taxable year in question.

Declaratory judgments

Under the bill, once the IRS notifies an organization that it intends to revoke its status as a church, or that it intends to assess taxes for unrelated business income against the organization, the organization would be deemed to have exhausted its administrative remedies for purposes of the declaratory judgment provision of the Code (sec. 7428). The organization would thus be entitled to bring a declaratory judgment action to preserve its tax-exempt status without awaiting further IRS action.

Injunctive relief

The bill would entitle any organization claiming that the IRS has violated the restrictions on investigation and examination of churches (including the requirement of a determination within one year) to seek an injunction against further violations. Jurisdiction for the suit would be in the United States district courts. If it prevailed in the suit, the organization would be entitled to an award of reasonable attorneys' fees under section 7430 of the Code.

D. Effective Date

The provisions of the bill would be effective with regard to investigations, examinations, and proceedings commencing after the date of enactment.

○

Senator **Grassley**. I would like to call this meeting of the Subcommittee on Oversight of the Internal Revenue Service to order. The topic of today's subcommittee hearing is the procedure employed by the Internal Revenue Service to audit religious organizations as a corollary to investigating current practices. I would like to focus on how Church Audit Procedures Act might clarify certain procedures, and address some of the shortcomings in current church audit practice.

I became interested in church audit procedures under the Internal Revenue Code when I chaired a hearing in this subcommittee on the Taxpayer Protection and Reimbursement Act of 1981. That legislation contained a provision for reimbursement of attorney's fees to those who suffer Government actions that are proven unsuccessful or baseless.

At those hearings, testimony was presented by a witness representing an audited church whose congregation spent thousands of dollars and expended hundreds of man-hours during an examination by the IRS. The audit resulted in exoneration, but I was struck by how quickly the integrity, character, and moral foundation of small congregations could be undermined by innuendo, rumor, and press coverage during the extended IRS examinations.

I became convinced that the problem touched upon in the testimony deserved more serious investigation. The entire issue of auditing churches must be viewed from a constitutional perspective.

The first amendment guarantees citizens the right to freely exercise their religious conviction, and prevents Federal establishment of religion. Among all of our cherished first amendment freedoms, freedom of religion is one of the most zealously protected. Our republic was founded by individuals who fled religious persecution and risked their lives in a new and untamed land to freely practice their religious beliefs. So there is no question of the historical basis for concern about freedom of religion.

Historically, there has been tension between the right of religious organizations to be free from governmental interference in their exercise of religion and the proper degree of power allowed the Government to seek information from those organizations. Recognizing the sensitivity of Government examination of religious organizations, some tax evaders have sought refuge in alleged religious organizations to avoid paying taxes. This misuse of religious forum has increased the tension between the Government and churches as the IRS attempts to determine who is claiming to be a church for tax shelter purposes.

This interface between the church and state needs to be examined by this Congress to be certain the first amendment rights of churches are not trampled in the Government's zeal to collect revenue.

Not only is it important to review the IRS' church current audit practices and procedures to assess whether they pass constitutional muster, we must all look to the future to be certain safeguards sufficiently exist to protect religious organizations.

Under the guidance of Commissioner Egger and many of his predecessors, the IRS has tried to exercise extreme caution in the audit of churches. Nevertheless, it is critical that we examine existing church audit procedures to be certain they adequately protect churches from capricious meddling by future IRS personnel. We need to be rigorous in our analysis of IRS practices to establish whether existing safeguards protect these important constitutional freedoms.

The Commissioner will outline current church audit procedures and critique the provisions of S. 1262, my bill, which was also introduced by Congressman Mickey Edwards in the House. It creates new pre-examination rights for churches. S. 1262 requires the IRS to have evidence before commencing an examination. And it requires the Service to notify the taxpayer in writing about the reasons for the audit, the information the IRS hopes to discover, the specific code sections which are at issue, and also an explanation of the organization's rights. Before an examination is undertaken under this bill, the regional council as well as the regional commissioner must approve the audit. Also, the IRS must offer the taxpayer a conference to discuss the evidence obtained by the IRS and the issues to be explored during the audit prior to sending the notice of intent to examine.

These provisions are designed to apprise a church of the issues likely to be examined and to flay any possible misunderstanding before formal examination begins.

It is a feeling of many members of the religious community that these preexamination notices and meetings will assist both parties in clarifying misunderstandings and increasing cooperation among the parties.

My bill also requires the IRS to complete an audit within 365 days of its inception. This provision is crafted to require the IRS to be focused and expeditious in its inquiry to avoid unconstitutional entanglement.

If a church initiates a judicial challenge or refuses to comply with the IRS' reasonable request, the time limit, then, is told. Taxpayers who file returns may be audited for 3 prior years. Often tax exempt taxpayers do not file returns. Thus, they have unlimited open years for audit and potential back tax liability.

This bill limits a churches open audit years to 3 prior years to limit its tax liability. The bill also requires the IRS to assess the tax if the church has paid a portion of the liability before proceeding to court for collection.

These provisions are designed to reduce a churches' exposure for back taxes and to provide them and the institution with every opportunity to pay the deficiency.

Last, this bill permits a church to proceed to court rather than exhaust its administrative remedies within the IRS when a church has been notified that its tax exempt status is revoked, or if the IRS intends to levy a tax on unrelated business income. While the IRS rarely favors side-stepping its administrative procedures, it seems that little would be gained by requiring churches to proceed through the administrative network when the regional commissioner and regional council are required to approve the examination at the outset.

I look forward to the comments of the witnesses on possible refinement to this legislation. My goal is to minimize any conflict between churches and the IRS when an audit is deemed to be necessary. If this hearing unearths factual disputes about the extent of the church audit problem, I will consider requesting the Joint Committee on Taxation to examine prior audit cases to resolve any dispute about the issues.

Again, we cannot merely confine our inquiry to the past inequities. We must closely study our current procedures to be certain they adequately protect churches in the future when we may be unable to guarantee a responsible administration of the agencies.

All right. Our first witness is here, I believe. Congressman Mickey Edwards. Congressman Edwards, as I used to refer to you in the House as Mickey, we would appreciate it if you would come and give your testimony. And if you want to summarize, it will be printed in the record as submitted. And I would ask you to proceed, and encourage you to go ahead right now.

STATEMENT OF HON. MICKEY EDWARDS, A U.S. REPRESENTATIVE, STATE OF OKLAHOMA

Mr. **Edwards**. First of all, Chuck, let me say I don't mind if you still call me Mickey.

Senator **Grassley**. All right.

Mr. **Edwards**. The relationships between the House and Senate have not deteriorated that much.

Mr. Chairman, thank you for giving me the opportunity to speak in support of the Church Audit Procedures Act. I will just make a very brief statement, and respond to any questions you have.

We've come a very long way with this legislation since I first introduced it in the House of Representatives during the 97th Congress. And that progress that we have made is very largely due to your own active sponsorship of the bill in the Senate, and the leadership that you have taken on this bill. I personally appreciate that very much, as I know very many of the witnesses who will be here today also appreciate it.

The thing many Americans don't understand is that many churches must deal with the Internal Revenue Service on a regular basis, whether that is through the voluntary filing of a form 990 each year, or through required reports concerning social security taxes for lay employees. The Congress has, over the years, brought churches into the tax code and under the scrutiny of the Internal Revenue Service. Unfortunately, at the same time, the Congress has failed to spell out clearly enough its intended protection for the churches. This deficiency in current law is the reason the Church Audit Procedures Act is before the Congress today.

The list of supporters for this legislation includes individuals and representatives of organizations from very different parts of the political spectrum. It is that diversity of support for this act that fuels my optimism about the prospects of success for this bill.

I believe that we have been able to construct this extraordinary coalition because of the basic theme of the Church Audit Procedures Act, which is simply fairness. Despite current law and current IRS guidelines, we have found that churches have sometimes been denied basic information about IRS investigation or examination procedures. As you will hear in greater detail later this morning from other witnesses, some churches have been unable to learn why they are being investigated, what the IRS is seeking to discover, and what IRS procedures they will be asked to comply with.

It is this basic concept of fairness that has allowed this act to garner the kind of broad ranging support that is evidenced by your witnesses today, and by the extraordinary array of grassroots organizations which have helped us already to gain 75 cosponsors in the House of Representatives. Leaders of such diverse organizations as the National Association of Christians and Jews, the Moral Majority, the National Council of Churches, the New York Civil Liberties Union, Christian Voice, the Evangelical Council for Financial Accountability, the National Association of Evangelicals, the General Association of Regular Baptist Churches, the Church of the Bible Covenant, and the National Christian Action Coalition have all voiced support for the principles of the Church Audit Procedures Act. Through their newsletters, television and radio broadcasts, and other forms of communication, they have motivated thousands of Americans to urge their Members of Congress to support this act.

I will not recite the list of House cosponsors of the act, but would like, with your permission, to submit the list for the committee record because it so clearly demonstrates the broad bipartisan support for this act.

[The list from Congressman Edwards follows:]

MICKEY EDWARDS
FIFTH DISTRICT, OKLAHOMA

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ON ENTITLEMENT REFORM

Congress of the United States
House of Representatives
Washington, D.C. 20515

2434 Rayburn House Office Building
Washington, D.C. 20515
(202) 225-2132

DISTRICT OFFICES
1200 SE Frank Phillips Boulevard, Suite 102
Bartlesville, OK 74003
(918) 336-5438

812 Old Post Office Building
Oklahoma City, OK 73102
(405) 231-4541

114 North 4th, Suite 108
Ponca City, OK 74601
(405) 762-8121

September 29, 1983

CO-SPONSORS - HR 2977 - CHURCH AUDIT PROCEDURES ACT

Dymally
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Hall, Tony
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Campbell
Bliley
Emerson
Daniel
Quillen
Rudd
Parris
Hunter
Durbin
Crane, Phil
Sensenbrenner
Whittaker
Hiler
Burton, Dan
Dyson
Hansen, George
Wolf
Andrews, Mike
Simon
Pashayan
Coats
Solomon
Montgomery
Dreier
Kemp
Dellums
Crockett
Broomfield
Nielson
Gekas
Pursell
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Wilson
Ritter
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Pritchard
Paul
Myers
Bevill
Savage
VanderJagt
DeWine
Stangeland
Livingston
Courter
Lowery, Bill
Gingrich
Lott
Weber
Thomas, Bill
Vandergriff
Porter
Gramm
Tallon
Forsythe
Watkins
Moorhead
Smith, Chris
Lewis, Tom
Chappell
Britt
Patman
Hance
Shelby
Badham
Daub
Dannemeyer
Barnard
McEwen
Glickman

Mr. **Edwards**. Among the current list of cosponsors in the House, where we have a very broad diversity of opinions, are liberals, conservatives, boll weevils, gypsy moths, members of the Black Caucus, and the Republican regulars, representing a total of 30 States. This is a remarkable level of support, especially when you consider how few people knew anything about this issue or this legislation when the act was first introduced just a year ago.

There is a very important point I would like to make to the committee and to the representatives of the Internal Revenue Service. Despite this rapidly expanding base of support for the act and its goals, you should be aware of the deep appreciation for the IRS efforts to uncover organizations which seek to evade taxes by fraudulently portraying themselves as churches. No one and no organization working on behalf of this act is opposed to the legitimate efforts by the IRS to uncover this fraud and to prosecute the individuals involved. However, while we recognize the difficulty of the task, we cannot allow constitutional protections of religious freedom to be pushed aside. Unfortunately because Congress has up to now not clearly defined the guidelines for IRS audits and investigations, the constitutional protections are, in some cases, ignored. Not as a matter of IRS policy, but of practice.

Senator, I am going to stop there because the witnesses who are going to come after me are far better prepared to deal with the examples that they have run across than I am.

I'll be happy to answer any questions.

Senator **Grassley**. I want to thank you for your testimony. I do have a couple of questions. I want to commend you for your leadership, and also want to invite you if, when you are done at the witness table, you want to come and sit here with me and participate, you are welcome to do that.

Mr. **Edwards**. I appreciate that very much. The House goes into session in 20 minutes, and I don't know if I will be able to.

Senator **Grassley**. All right.

I'm sure you are aware of the exceptional developments in the recent days regarding support for the Church Audit Procedures Act. I want to commend you for your efforts. And I want to paraphrase Shakespeare and to say that I am pleased that the administration has come not to bury this bill, but to rather somewhat praise it.

Mr. **Edwards**. I'm delighted about that, too.

Senator **Grassley**. That makes me feel very good. And it also makes me feel good about the chances of getting the legislation passed.

I would like to have in a general way the type of complaints from churches which motivated you to draft this bill.

Mr. **Edwards**. I think those problems fall generally into two categories. And the first includes the IRS procedures for conducting investigations of churches. What usually happens is that the churches will receive a letter from the IRS that requests a great deal of detailed information about their financial and religious activities without giving the churches any real indication of what they are being accused.

And, in addition, the questions are accompanied often by a statement that says if you do not provide the requested information in a timely manner, we will issue an adverse determination letter proposing to revoke or deny your exemption from Federal income tax. I really believe that that is an unnecessarily adverse and antagonistic process.

I know that many of the churches would have been happy to cooperate with the IRS if they had been provided with some basic information about the nature of the IRS' concerns.

The second category of problems is probably more important. And that is the basic flaws in the Tax Code with respect to the policies regarding examinations and the statute of limitations. And those, I think, absolutely require a congressional remedy rather than just guidelines, which is why we proposed that, you and I, in this legislation.

Senator **Grassley**. After the benefit of criticism from a variety of groups that I am sure you have had ample contact with in recent months, are there any refinements you would make in the legislation which is now before this committee?

Mr. **Edwards**. There are some, and I think, as you know we have in putting this bill together, your office and mine, consulted with many legal and constitutional experts, with religious experts and people at the IRS, Treasury Department and others, and as a result of what they have said and what we have heard from the churches, I would like to see some language added that would retain the penalties for churches which are required to file tax returns but fail to do so. These would be churches, for example, that may have unrelated business income. We don't mean in this legislation to try to protect delinquent churches from penalties that ought to be assessed.

I would like to see a refinement of the legislation which would guarantee also that the protections of the statute of limitations accrue only to those who have met their legal responsibilities. We are trying to refine the procedures here to give protection to innocent churches. We are not trying to find a way for churches that are doing fraudulent business to avoid their proper penalties.

Senator **Grassley**. Those are the only questions I have. I look forward to working with you as this legislation evolves through the legislative process.

Mr. **Edwards**. Thank you. I, again, want to say we have made a tremendous amount of progress which we have referred to both in the number of supporters we have gained in Congress and from outside the Congress, and now the statements from the administration. And a great deal of that is because you introduced the bill in the Senate, and the leadership you have taken. And on behalf of all 75 of us in the House who are working for this legislation, I want to let you know how much we appreciate that.

Senator **Grassley**. Well, thank you, Mickey.

[The prepared statement of Congressman Edwards follows:]

STATEMENT OF CONGRESSMAN MICKEY EDWARDS, IN SUPPORT OF THE CHURCH AUDIT PROCEDURES ACT

MR. CHAIRMAN, THANK YOU FOR GIVING ME THE OPPORTUNITY TO SPEAK IN SUPPORT OF THE CHURCH AUDIT PROCEDURES ACT. WE HAVE COME A LONG WAY WITH THIS LEGISLATION SINCE I FIRST INTRODUCED IT IN THE HOUSE OF REPRESENTATIVES DURING THE 97th CONGRESS AND THAT IS LARGELY DUE TO YOUR OWN ACTIVE SPONSORSHIP OF THE BILL IN THE SENATE.

MANY AMERICANS DO NOT UNDERSTAND THAT CHURCHES MUST DEAL WITH THE INTERNAL REVENUE SERVICE ON A REGULAR BASIS, WHETHER THROUGH THE VOLUNTARY FILING OF A FORM 990 EACH YEAR, OR THROUGH REQUIRED REPORTS CONCERNING SOCIAL SECURITY TAXES FOR LAY EMPLOYEES. THE CONGRESS HAS, OVER THE YEARS, BROUGHT CHURCHES INTO THE TAX CODE AND UNDER THE SCRUTINY OF THE INTERNAL REVENUE SERVICE. UNFORTUNATELY, AT THE SAME TIME, CONGRESS HAS FAILED TO SPELL OUT CLEARLY ENOUGH ITS INTENDED PROTECTIONS FOR CHURCHES. THIS DEFICIENCY IN CURRENT LAW IS THE REASON THE CHURCH AUDIT PROCEDURES ACT IS BEFORE THIS CONGRESS TODAY.

THE LIST OF SUPPORTERS FOR THIS LEGISLATION INCLUDES INDIVIDUALS AND REPRESENTATIVES OF ORGANIZATIONS FROM VERY DIFFERENT PARTS OF THE POLITICAL SPECTRUM. IT IS THAT DIVERSITY OF SUPPORT FOR THIS ACT THAT FUELS MY OPTIMISM ABOUT THE PROSPECTS OF SUCCESS FOR THIS LEGISLATION.

I BELIEVE WE HAVE BEEN ABLE TO CONSTRUCT THIS EXTRAORDINARY COALITION BECAUSE OF THE BASIC THEME OF THE CHURCH AUDIT PROCEDURES ACT: FAIRNESS. DESPITE CURRENT LAW AND CURRENT IRS GUIDELINES, WE HAVE FOUND THAT CHURCHES HAVE SOMETIMES BEEN DENIED BASIC INFORMATION ABOUT IRS INVESTIGATION OR EXAMINATION PROCEDURES. AS YOU WILL HEAR IN GREATER DETAIL LATER THIS MORNING, SOME CHURCHES HAVE BEEN UNABLE TO LEARN WHY THEY ARE BEING INVESTIGATED, WHAT THE IRS IS SEEKING TO DISCOVER AND WHAT IRS PROCEDURES THEY WILL BE ASKED TO COMPLY WITH.

IT IS THIS BASIC CONCEPT OF FAIRNESS THAT HAS ALLOWED THIS ACT TO GARNER THE KIND OF BROAD-RANGING SUPPORT EVIDENCED BY YOUR WITNESSES TODAY AND BY THE EXTRAORDINARY ARRAY OF GRASSROOTS ORGANIZATIONS WHICH HAVE HELPED US GAIN 75 CO-SPONSORS IN THE HOUSE OF REPRESENTATIVES. LEADERS OF SUCH DIVERSE ORGANIZATIONS AS THE NATIONAL ASSOCIATION OF CHRISTIANS AND JEWS, THE MORAL MAJORITY, THE NATIONAL COUNCIL OF CHURCHES, THE NEW YORK CIVIL LIBERTIES UNION, CHRISTIAN VOICE, THE EVANGELICAL COUNCIL FOR FINANCIAL ACCOUNTABILITY, THE NATIONAL ASSOCIATION OF EVANGELICALS, THE GENERAL ASSOCIATION OF REGULAR BAPTIST CHURCHES, THE CHURCH OF THE BIBLE COVENANT AND THE NATIONAL CHRISTIAN ACTION COALITION HAVE VOICED SUPPORT FOR THE PRINCIPLES OF THE CHURCH AUDIT PROCEDURES ACT. THROUGH THEIR NEWSLETTERS, TELEVISION AND RADIO BROADCASTS AND OTHER FORMS OF COMMUNICATION, THEY HAVE MOTIVATED THOUSANDS OF AMERICANS TO URGE THEIR MEMBERS OF CONGRESS TO SUPPORT THIS ACT.

I WILL NOT RECITE THE LIST OF HOUSE CO-SPONSORS OF THE CAP ACT, BUT I WOULD LIKE WITH YOUR PERMISSION TO SUBMIT THE LIST FOR THE COMMITTEE RECORD, BECAUSE IT SO CLEARLY DEMONSTRATES THE

BROAD, BI-PARTISAN SUPPORT FOR THIS ACT. AMONG THE CURRENT LIST OF CO-SPONSORS IN THE HOUSE ARE LIBERALS, CONSERVATIVES, BOLL WEEVILS, GYPSY MOTHS, MEMBERS OF THE BLACK CAUCUS AND THE REPUBLICAN REGULARS, REPRESENTING A TOTAL OF 30 STATES. THIS IS A REMARKABLE LEVEL OF SUPPORT, ESPECIALLY WHEN YOU CONSIDER HOW FEW PEOPLE KNEW ANYTHING ABOUT THIS ISSUE OR THIS LEGISLATION WHEN WE FIRST INTRODUCED THE CAP ACT JUST ONE YEAR AGO.

THERE IS A VERY IMPORTANT POINT I WOULD LIKE TO MAKE TO THE COMMITTEE AND TO THE REPRESENTATIVES OF THE INTERNAL REVENUE SERVICE. DESPITE THIS RAPIDLY EXPANDING BASE OF SUPPORT FOR THE CAP ACT AND ITS GOALS, YOU SHOULD BE AWARE OF THE DEEP APPRECIATION FOR THE IRS'S EFFORTS TO UNCOVER ORGANIZATIONS WHICH SEEK TO EVADE TAXES BY FRAUDULENTLY PORTRAYING THEMSELVES AS A CHURCH. NO ONE, AND NO ORGANIZATION WORKING ON BEHALF OF THE CAP ACT, IS OPPOSED TO LEGITIMATE EFFORTS BY THE IRS TO UNCOVER THIS FRAUD AND TO PROSECUTE THE INDIVIDUALS INVOLVED. HOWEVER, WHILE WE RECOGNIZE THE DIFFICULTY OF THIS TASK, WE CANNOT ALLOW CONSTITUTIONAL PROTECTIONS OF RELIGIOUS FREEDOM TO BE PUSHED ASIDE. UNFORTUNATELY, BECAUSE CONGRESS HAS NOT UP TO NOW CLEARLY DEFINED THE GUIDELINES FOR IRS AUDITS AND INVESTIGATIONS, THE CONSTITUTIONAL PROTECTIONS ARE, IN SOME CASES, IGNORED -- NOT AS A MATTER OF IRS POLICY, BUT OF PRACTICE.

SENATOR, ALTHOUGH THE OTHER WITNESSES WHO WILL TESTIFY TODAY IN SUPPORT OF THE CAP ACT ARE BETTER PREPARED TO DISCUSS IN DETAIL

HOW CURRENT LAW AND CURRENT IRS GUIDELINES HAVE PROVEN INADEQUATE IN PROTECTING CHURCHES, I WOULD LIKE TO BRIEFLY EXPLAIN THE PROVISIONS OF THE CAP ACT AND STATE THE REASONS FOR INCLUDING EACH IN THE CHURCH AUDIT PROCEDURES ACT.

SECTION 2(a) OF THE CAP ACT IS ENTITLED "RESTRICTIONS ON EXAMINATION OF CHURCHES." THIS PROVISION INCLUDES THE REQUIREMENT THAT THE IRS POSSESS EVIDENCE EVOKING A REASONABLE BELIEF THAT A CHURCH IS ENGAGED IN AN UNRELATED BUSINESS OR IS, IN FACT, NOT A CHURCH, BEFORE PROCEEDING WITH ANY INVESTIGATION. THIS PROVISION PROTECTS CHURCHES AGAINST IRS "FISHING EXPEDITIONS,". WHEREIN THE IRS MAY DEMAND DETAILED FINANCIAL AND RELIGIOUS INFORMATION FROM A CHURCH WITHOUT ANY EVIDENCE BEFOREHAND THAT THE CHURCH MAY BE VIOLATING THE TAX CODE. WHILE THE IRS CANNOT TELL US HOW MANY OF THESE PRE-EXAMINATION PROCEDURES ARE STARTED EACH YEAR, WE HAVE BEEN ABLE TO LEARN THAT NEARLY 200 PRE-EXAMINATION PROCEDURES WERE "CLOSED" DURING THE LAST THREE CALENDAR YEARS. IN OTHER WORDS, AT LEAST 200 CHURCHES WERE INVOLVED IN A PRE-EXAMINATION PROCESS WITH THE INTERNAL REVENUE SERVICE DURING THE LAST THREE YEARS ABSENT ANY REQUIREMENT BY CONGRESS THAT THE IRS HAS SOME REASON TO BELIEVE THAT THE CHURCH IS IN SOME WAY VIOLATING THE TAX CODE.

SECTION 2 ALSO REQUIRES THAT THE CHURCHES BE NOTIFIED BY THE IRS WHEN AN INVESTIGATION IS BEING COMMENCED. UNDER CURRENT IRS GUIDELINES, SUCH NOTIFICATION IS NOT REQUIRED UNTIL PERMISSION TO AUDIT HAS BEEN APPROVED.

I BELIEVE THIS EARLIER NOTIFICATION WILL ALLOW CHURCHES TO BETTER PREPARE THEIR RECORDS AND PERMIT THEM TO COOPERATE MORE EFFECTIVELY WITH IRS INVESTIGATIONS.

SECTION 3 OF THE CAP ACT REQUIRES CONCURRENCE BY THE IRS REGIONAL COUNSEL BEFORE AN ACTUAL EXAMINATION OF CHURCH RECORDS OR RELIGIOUS ACTIVITIES MAY TAKE PLACE. CURRENTLY, THE REGIONAL COMMISSIONER MAKES THIS DETERMINATION. THIS PROVISION WILL HELP GUARD AGAINST UNNECESSARY AUDITS BY PLACING THE DECISION IN THE HANDS OF THE TWO PRINCIPLE IRS REGIONAL REPRESENTATIVES.

SECTION 4 PROVIDES THE CHURCHES WITH THE OPPORTUNITY TO MEET FACE-TO-FACE WITH IRS REPRESENTATIVES IN AN ATTEMPT TO WORK OUT ANY PROBLEMS. AS SUBSEQUENT WITNESSES WILL TESTIFY, THIS SIMPLE, INFORMAL PROCEDURE COULD SAVE THE CHURCHES AND THE TAXPAYER A GREAT DEAL OF EXPENSE.

SECTION 5 IS THE SECOND NOTICE REQUIREMENT, WHICH STATES THAT THE CHURCH MUST BE GIVEN 15 DAYS NOTICE PRIOR TO AN AUDIT. THIS IS ALREADY A PART OF CURRENT IRS GUIDELINES AND SHOULD CONTINUE THROUGH THIS STATUTE.

SECTION 6 IS AN EXTREMELY IMPORTANT ELEMENT OF THIS BILL, BECAUSE IT CLARIFIES LONG-STANDING CONGRESSIONAL POLICY FORBIDING IRS EXAMINATION OF RELIGIOUS ACTIVITIES OF CHURCHES, EXCEPT TO THE EXTENT NECESSARY TO DETERMINE WHETHER THE ORGANIZATION IS, IN FACT, A CHURCH. THIS PROVISION IS SIMILAR TO CURRENT SECTION 7605(c) OF THE TAX CODE, WHICH WAS ADDED AS PART OF THE TAX REFORM ACT OF 1969, WHEN, FOR THE FIRST TIME, UNRELATED BUSINESS INCOME OF CHURCHES BECAME TAXABLE. UNFORTUNATELY, THE CURRENT LAW IS VAGUE AND WAS NOT ACCOMPANIED BY ADEQUATE STATEMENT OF LEGISLATIVE INTENT TO GUIDE THE COURTS IN DETERMINING ITS SCOPE. THEREFORE, IT IS NECESSARY TO RESTATE THIS PROVISION IN MORE PRECISE FASHION AND TO STATE THE INTENTION THAT THIS PROVISION SHOULD CONSTRAIN THE INTERNAL REVENUE SERVICE FROM SEEKING TO EXAMINE RELIGIOUS ACTIVITIES, UNLESS THE PURPOSE OF THE EXAMINATION IS TO DETERMINE CHURCH STATUS. EXAMINATION OF RELIGIOUS ACTIVITIES SHOULD BE ALLOWED BY THE COURTS FOR NO OTHER PURPOSE.

SECTION 7 PLACES A TIME LIMIT ON THE IRS INVESTIGATION, BY REQUIRING THAT A DETERMINATION BE MADE WITHIN ONE YEAR (365 DAYS). THIS 365 DAY TIME PERIOD BEGINS ON THE DATE THE CHURCH IS FIRST NOTIFIED BY THE IRS THAT AN INVESTIGATION HAS BEGUN. THE ACT DOES ALLOW FOR ANY PERIOD OF TIME DURING WHICH THE IRS CANNOT PROCEED WITH AN INVESTIGATION DUE TO COURT PROCEEDINGS BROUGHT BY THE CHURCH OR DUE TO FAILURE OF A CHURCH TO COMPLY WITH REASONABLE IRS REQUESTS FOR INFORMATION.

SECTION 8 PROVIDES THE CHURCH WITH THE OPPORTUNITY TO SEEK INJUNCTIVE RELIEF IN ORDER TO PROTECT ITSELF AND INCLUDES CHURCHES AMONG OTHER TAXPAYERS WHO MAY TRY TO RECOVER COURT

COSTS AND ATTORNEY'S FEES FROM THE FEDERAL GOVERNMENT WHEN THEY SUCCESSFULLY DEFEND THEMSELVES AGAINST THE IRS.

SECTION 8(b) EXTENDS THE STANDARD, THREE-YEAR STATUTE OF LIMITATIONS TO CHURCHES. CURRENTLY, THERE IS NO PROVISION IN THE CODE WITH RESPECT TO THE STATUTE OF LIMITATION TO ACCOUNT FOR THE FACT THAT MOST CHURCHES DO NOT AND ARE NOT REQUIRED TO FILE TAX RETURNS. AS A RESULT, FOR THE PURPOSES OF THE STATUTE OF LIMITATIONS, CHURCHES HAVE BEEN INVESTIGATED AS IF THEY HAD FAILED TO FILE A REQUIRED RETURN. I BELIEVE THAT CHURCHES, EVEN THOSE WHICH DO NOT FILE RETURNS, SHOULD HAVE THE PROTECTION OF A STATUTE OF LIMITATION. AND, BECAUSE WE WANT TO MAKE A CLEAR DISTINCTION BETWEEN CHURCHES WHICH ARE NOT REQUIRED TO FILE AND THOSE WHO FAIL TO FILE, I WOULD SUPPORT ADDITIONAL LANGUAGE TO MAKE DELINQUENT CHURCHES SUBJECT TO THE SAME PENALTIES AS INDIVIDUALS WHO FAIL TO MEET THE REQUIREMENTS OF THE LAW.

THE FINAL SUBSTANTIVE PROVISION, SECTION 8(c) ALLOWS THE CHURCHES TO PROCEED DIRECTLY TO A COURT OF LAW ONCE THEY RECEIVE AN ADVERSE DETERMINATION FROM THE INTERNAL REVENUE SERVICE. CURRENTLY, CHURCH OFFICIALS ARE REQUIRED TO FIRST EXHAUST ALL INTERNAL ADMINISTRATIVE REMEDIES AVAILABLE. CONSIDERING THE INVOLVEMENT OF BOTH THE REGIONAL COMMISSIONER AND THE REGIONAL COUNSEL IN THE AUDIT APPROVAL PROCESS, PLUS THE CONFERENCE REQUIREMENT, IT IS EXCESSIVE TO REQUIRE THE CHURCH TO ENDURE MORE INTERNAL IRS PROCEEDINGS BEFORE ATTEMPTING TO SECURE A JUDICIAL REMEDY.

I BELIEVE THE CHURCH AUDIT PROCEDURES ACT WILL BECOME LAW DURING THE 98th CONGRESS. ITS GROWING SUPPORT ACROSS THE COUNTRY AND WITHIN THIS BODY IS CLEARLY EVIDENT. WITH THAT OPTIMISM IN MIND, IT IS IMPORTANT TO DIRECT A CONCERN TO THE INTERNAL REVENUE SERVICE ABOUT THE PROCESS OF IMPLEMENTING THE REQUIREMENTS OF THIS ACT. AS WE KNOW, THERE IS NO HARD AND FAST, UNEQUIVOCAL DEFINITION OF WHAT IS A CHURCH. IT IS NOT POSSIBLE, GIVEN THE PROTECTIONS FOR RELIGIOUS FREEDOM IN THE U.S. CONSTITUTION, FOR CONGRESS TO APPROVE A LAW THAT WOULD DEFINE A CHURCH. THEREFORE, HISTORICALLY, WE HAVE RELIED ON GUIDELINES TO ASSIST THE INTERNAL REVENUE SERVICE AND THE COURTS IN MAKING DETERMINATIONS OF CHURCH STATUS. IT'S MY CONCERN THAT WHEN THIS ACT BECOMES PART OF THE TAX CODE, THAT NO EFFORT BE MADE TO CONSTRICT CURRENT GUIDELINES USED TO DETERMINE CHURCH STATUS, SO AS TO SERIOUSLY LIMIT THE NUMBER OF CHURCHES WHO WILL BE AFFORDED THE PROTECTION OF THIS LEGISLATION. THERE IS A NEED FOR THE IRS TO WORK WITH CHURCHES IN ORDER TO DEAL WITH THE PROBLEMS CREATED BY MAIL-ORDER MINISTRIES AND OTHER SCHEMES OF TAX EVASION AND, I WOULD STRONGLY URGE THE IRS TO MOVE QUICKLY IN ASKING FOR THAT ASSISTANCE.

THANK YOU AGAIN, SENATOR, FOR THIS OPPORTUNITY AND I AM GRATEFUL FOR YOUR HELP AND FOR THE PRESENCE TODAY OF SOME FINE INDIVIDUALS WHO WILL ADD THEIR VOICES IN SUPPORT OF THE CHURCH AUDIT PROCEDURES ACT.

THANK YOU.

Senator **Grassley**. Our next witness—I am going to ask both the Treasury, which will be represented by Mr. Pearlman as opposed to Mr. Chapoton on our witness list, and also Roscoe Egger—both of you have been before this committee so often and are so well known by everybody, including those in the audience, I won't take time to introduce you.

Mr. Egger is the one on my left. Mr. Pearlman is the one on my right. I would ask either one of you to make a decision as to which one should go first.

Commissioner **Egger**. Mr. Chairman, we have agreed that I would make my testimony first, which will deal basically with our procedures. And then Mr. Pearlman will address the Treasury comments on the total legislation.

Senator **Grassley**. All right. Proceed.

STATEMENT OF HON. ROSCOE L. EGGER, JR., COMMISSIONER, INTERNAL REVENUE SERVICE, WASHINGTON, D.C.

Commissioner **Egger**. I would like to, with your permission, present a shortened version of the prepared statement.

Senator **Grassley**. And you want your entire prepared statement inserted in the record.

Commissioner **Egger**. Yes, I would like to do that, Mr. Chairman.

[The prepared statement of Commissioner Egger follows:]

TESTIMONY

OF THE

COMMISSIONER OF INTERNAL REVENUE
HONORABLE ROSCOE L. EGGER, JR.

BEFORE

UNITED STATES SENATE
COMMITTEE ON FINANCE
SUBCOMMITTEE ON OVERSIGHT OF
THE INTERNAL REVENUE SERVICE

HEARING ON PROPOSED S.1262
CHURCH AUDIT PROCEDURES ACT

SEP 3 0 1983

MR. CHAIRMAN, I THANK YOU AND THE SUBCOMMITTEE FOR THE OPPORTUNITY TO DESCRIBE THE INTERNAL REVENUE SERVICE AUDIT PROCEDURES FOR CHURCHES AND RELATED PARTIES.

WE IN THE INTERNAL REVENUE SERVICE ARE KEENLY AWARE OF THE SENSITIVE NATURE OF THE CHURCH-STATE RELATIONSHIP AND RECOGNIZE THE IMPORTANCE OF THE FIRST AMENDMENT'S CONSTITUTIONAL MANDATE THAT GOVERNMENT INTERFERENCE WITH THE FREE EXERCISE OF RELIGION BE LIMITED TO CASES OF COMPELLING GOVERNMENT INTEREST AND BE RESTRICTED TO THE EXTENT NECESSARY TO ENFORCE THAT INTEREST. VERY SPECIFIC FEDERAL STATUTES AND CASE LAW PRESCRIBE INTERNAL REVENUE SERVICE TREATMENT OF CHURCHES AND RELATED PARTIES TO GUARANTEE COMPLIANCE WITH THE CONSTITUTIONAL MANDATE. IN MY TESTIMONY TODAY, I WILL OUTLINE THE RULES GOVERNING SERVICE EXAMINATIONS OF CHURCHES AND EXPLAIN HOW THOSE EXAMINATIONS

ARE CONDUCTED. IN ADDITION, I WILL COMMENT ON THE PROCEDURES VOLUNTARILY INSTITUTED BY THE SERVICE WHICH WE FEEL GO WELL BEYOND THE MINIMUM LEGAL REQUIREMENTS IN AN EFFORT TO COMPLY WITH THE SPIRIT OF THE LAW.

FIRST, LET ME STATE THE OBVIOUS. THE INTERNAL REVENUE SERVICE HAS A CLEAR CUT OBLIGATION TO ENFORCE THE FEDERAL TAX LAW WITH THE RESPECT TO ALL TAXPAYERS, INCLUDING CHURCHES IN APPROPRIATE CIRCUMSTANCES AND THOSE ORGANIZATIONS CLAIMING TO BE CHURCHES. THE COURTS HAVE CONSISTENTLY UPHELD OUR AUTHORITY TO EXAMINE SUCH ORGANIZATIONS. SEE, FOR EXAMPLE, DE LA SALLE INSTITUTE v. UNITED STATES, 195 F. SUPP. 891 (N.D. CAL. 1961); THE FOUNDING CHURCH OF SCIENTOLOGY v. UNITED STATES, 412 F.2D 1197 (CT. CL. 1969), CERT. DEN. 397 U.S. 1009 (1970); CHRISTIAN ECHOES NATIONAL MINISTRY, INC. v. UNITED STATES, 470 F.2D 849 (10TH CIR. 1972), CERT. DEN. 414 U.S. 864 (1973). THOSE CLAIMING THE LEGAL BENEFITS FLOWING FROM CHURCH STATUS NATURALLY MUST COMPLY WITH THE LAW PROVIDING THOSE SPECIAL BENEFITS. IT IS ONLY FAIR AND EQUITABLE TO ALL OTHER TAXPAYERS.

THE SERVICE RESTRICTS ITS CHURCH INQUIRIES TO MATTERS GERMANE TO THE DETERMINATION OF THE PROPER TAX STATUS OF CHURCHES AND RELATED PARTIES. CONTRARY TO SOME CLAIMS, WE DO NOT EXAMINE CHURCHES TO PASS ON THE LEGITIMACY OR MERITS OF INDIVIDUAL RELIGIOUS BELIEF. NO COURT REVIEWING OUR DENIAL OF EXEMPT CHURCH STATUS TO AN

ORGANIZATION HAS EVER FOUND THAT THE SERVICE BASED ITS DECISION ON A VALUE JUDGMENT ABOUT THE ORGANIZATION'S BELIEF. SEE, FOR EXAMPLE, BASIC BIBLE CHURCH v. COMMISSIONER, 74 T.C. 846 (1980); BUBBLING WELL CHURCH OF UNIVERSAL LOVE, INC. v. COMMISSIONER, 74 T.C. 513 (1980); CHURCH OF THE TRANSFIGURING SPIRIT, INC. v. COMMISSIONER, 76 T.C. 1 (1981); SOUTHERN CHURCH OF UNIVERSAL BROTHERHOOD ASSEMBLED, INC. v. COMMISSIONER, 74 T.C. 1223 (1980). JUDGMENTS BY US REGARDING THE NATURE OF RELIGIOUS BELIEF ARE BOTH REPUGNANT AND UNCONSTITUTIONAL. CURRENT LAW AND OUR ADMINISTRATIVE PROCEDURES EXPRESSLY FORBID THEM. WE EXPLICITLY INSTRUCT OUR EMPLOYEES THAT SUCH CONSIDERATIONS PLAY ABSOLUTELY NO PART IN A DETERMINATION OF ANY TAXPAYER'S LIABILITIES. WE HAVE RECOGNIZED, FOR EXAMPLE, THE EXEMPT CHURCH STATUS OF ORGANIZATIONS AS DIVERSE IN BELIEF AND PRACTICES AS A FUNDAMENTALIST CHRISTIAN COMMUNE, A HINDU ASHRAM, A GROUP OF SECULAR HUMANISTS, AND A SECT WORSHIPPING PAGAN DEITIES AND PRACTICING WITCHCRAFT.

HOWEVER, AS YOU KNOW, SOME INDIVIDUALS ATTEMPT TO AVOID THEIR INDIVIDUAL INCOME TAX LIABILITIES BY SETTING UP SHAM CHURCHES TO CLAIM THE VARIOUS TAX BENEFITS, DEDUCTIONS AND EXCLUSIONS AVAILABLE TO BONA FIDE CHURCHES AND MINISTERS. THESE TAX AVOIDANCE AND EVASION SCHEMES ARE JUST ANOTHER FORM OF ILLEGAL ACTIVITY THAT WE GENERICALLY LABEL "ILLEGAL TAX PROTEST". WE CANNOT TOLERATE THIS FORM OF TAX FRAUD. WE HAVE AN EXTENSIVE AND WELL-PUBLICIZED "ILLEGAL TAX PROTESTER" PROGRAM TO IDENTIFY, EXAMINE AND, IF APPROPRIATE, PROSECUTE TAXPAYERS

THAT FRAUDULENTLY CLAIM TAX EXEMPT CHURCH STATUS AND ITS ANCILLARY BENEFITS. THE WELL-KNOWN SCHEMES, MAIL-ORDER MINISTRIES, VOW OF POVERTY, ASSIGNMENT OF INCOME, ETC., ARE DESCRIBED IN OUR INTERNAL REVENUE MANUAL.

IN 1982, WE IDENTIFIED 11,087 INDIVIDUAL RETURNS ASSOCIATED WITH ALLEGED CHURCH TAX AVOIDANCE SCHEMES. FROM JANUARY TO JUNE 1983, WE IDENTIFIED 3093 SUCH RETURNS. DURING THE FIRST NINE MONTHS OF THIS FISCAL YEAR, WE CLOSED EXAMINATIONS OF 4221 CHURCH SCHEME RETURNS BY ASSESSING NEARLY $14,900,000 IN TAXES AND PENALTIES, AVERAGING $3530 PER RETURN. WE HAVE AN INVENTORY OF ALMOST 15,000 OPEN CHURCH SCHEME CASES. WE HAVE ALREADY OBTAINED A NUMBER OF CONVICTIONS IN THESE TYPE CASES AND WE CURRENTLY HAVE APPROXIMATELY 200 OPEN CRIMINAL INVESTIGATIONS. WE INTEND TO PURSUE THESE AND ALL FUTURE CHURCH SCHEME RETURNS AS VIGOROUSLY AS LEGALLY POSSIBLE. THIS OR ANY OTHER KIND OF TAX FRAUD HURTS ALL TAXPAYERS. TAX PROTESTERS WHO SHIRK THEIR TAX RESPONSIBILITIES ERODE THE REVENUE BASE BUT, MORE IMPORTANTLY, UNDERMINE THE HONEST CITIZEN'S CONFIDENCE IN THE SYSTEM.

HISTORICALLY, THE INTERNAL REVENUE CODE HAS EXEMPTED NONPROFIT CHURCHES AND RELIGIOUS ORGANIZATIONS FROM FEDERAL INCOME TAX. THIS EXEMPTION FOSTERS THE PROPER CONSTITUTIONAL SEPARATION BETWEEN CHURCH AND STATE, AND RECOGNIZES THE CHARITABLE NATURE OF SUCH ORGANIZATIONS. THE CURRENT PROVISION, SECTION 501(c)(3), EXEMPTS ORGANIZATIONS "ORGANIZED AND OPERATED EXCLUSIVELY FOR RELIGIOUS ... PURPOSES".

OF COURSE, THIS INCLUDES CHURCHES ALTHOUGH THEY ARE NOT SPECIFICALLY MENTIONED. SECTION 501(c)(3) CAREFULLY CONDITIONS EXEMPTION TO GUARANTEE THAT RELIGIOUS RATHER THAN PRIVATE, SELFISH INTERESTS ARE BEING FURTHERED. THUS, EXEMPTION IS DENIED WHEN THE ORGANIZATION'S NET EARNINGS INURE TO THE BENEFIT OF PRIVATE SHAREHOLDERS OR INDIVIDUALS, IF THE ORGANIZATION ENGAGES IN POLITICAL CAMPAIGNS ON BEHALF OF CANDIDATES, OR IF THE ORGANIZATION ENGAGES IN SUBSTANTIAL AMOUNTS OF LOBBYING OR LEGISLATIVE ACTION. CHURCHES ARE ALSO LIABLE FOR TAX ON INCOME FROM UNRELATED BUSINESS UNDER SECTION 511. TO DETERMINE A CHURCH'S PROPER TAX STATUS, THE SERVICE REVIEWS ALL INFORMATION BEARING ON WHETHER THE CHURCH MEETS THE CONDITIONS OF THE APPLICABLE CODE SECTION(S).

CODE SECTION 7602, AS AMPLIFIED BY SECTIONS 6001, 6033, 7605(c) AND THE UNDERLYING REGULATIONS, EMPOWERS THE SERVICE TO OBTAIN THE NECESSARY INFORMATION FROM CHURCHES. SECTION 7605(c) SETS OUT VERY SPECIFIC PARAMETERS FOR CHURCH EXAMINATIONS (WHICH I WILL DISCUSS IN DETAIL LATER). IT IS IMPORTANT HERE TO NOTE THAT SECTION 7605(c) WAS ENACTED IN 1969 TO CLARIFY HOW THE SERVICE SHOULD CONDUCT EXAMINATIONS OF CHURCH RECORDS AND AFFAIRS. SECTION 7605(c) WAS NOT ENACTED, AS SOME CRITICS ARGUE, TO REMOVE THE LONG-STANDING AUTHORITY OF THE SERVICE TO INQUIRE INTO THE TAX STATUS OF ORGANIZATIONS CLAIMING TO BE CHURCHES. ATTEMPTS TO GAIN JUDICIAL RECOGNITION OF THESE CRITICS' INTERPRETATION HAVE CONSISTENTLY FAILED. THE LEADING CASES UPHOLDING THE SERVICE

INTERPRETATION OF SECTION 7605(c) ARE UNITED STATES v. FREEDOM CHURCH, 613 F.2D 316 (1ST CIR. 1979); UNITED STATES v. EDWIN R. COATES (CHURCH OF REFLECTION), 692 F.2D 629 (9TH CIR. 1982); UNITED STATES v. DALE K. DYKEMA (CHURCH OF CHRISTIAN LIBERTY), 666 F.2D 1096 (7TH CIR. 1981), CERT. DEN. 456 U.S. 983 (1982), REH. DEN. 103 S. CT. 17 (1982). THESE CASES CONTAIN AUTHORITATIVE ANALYSES OF SECTION 7605(c) AND ITS LEGISLATIVE HISTORY.

EXEMPT CHURCH STATUS UNDER SECTIONS 501(c)(3) AND 170(B)(1)(A)(I) DETERMINES MOST OTHER TAX QUESTIONS INVOLVING CHURCHES AND RELATED PARTIES. FOR EXAMPLE, IT AFFECTS THE FEDERAL INSURANCE CONTRIBUTIONS ACT (FICA) AND FEDERAL UNEMPLOYMENT TAX ACT (FUTA) LIABILITIES OF A CHURCH AND ITS EMPLOYEES. SELF-EMPLOYMENT TAX ACT (SECA) LIABILITIES AND MINISTERS' TAX BENEFITS ARE LIKEWISE AFFECTED BY THE CHURCH EXEMPTION DETERMINATION. ALSO AFFECTED IS THE DEDUCTIBILITY OF CONTRIBUTIONS UNDER SECTION 170(c). THESE ANCILLARY BENEFITS ARE THE ONES THAT CHURCH SCHEME TAX PROTESTERS SEEK TO USE AS A WAY TO AVOID OR EVADE THEIR LEGITIMATE TAX LIABILITIES.

HERE, I SHOULD EMPHASIZE WHY WE MUST ASK CHURCHES FOR INFORMATION. UNDER SECTION 508(A), CHURCHES NEED NOT APPLY TO THE SERVICE FOR FORMAL RECOGNITION OF TAX EXEMPT STATUS, AND SECTION 6033 EXCEPTS CHURCHES FROM THE REQUIREMENT THAT THEY

FILE INFORMATION RETURNS (ALTHOUGH THEY ARE NOT EXCUSED FROM FILING TAX RETURNS ON THEIR UNRELATED BUSINESS). CONSEQUENTLY, WE HAVE AN INITIAL RECORD OF ONLY THOSE CHURCHES THAT VOLUNTARILY APPLY FOR AND FORMALIZE THEIR TAX EXEMPT STATUS. WE LEARN ABOUT THE OTHER CHURCHES COLLATERALLY FROM INFORMATION SUPPLIED BY COMPLAINANTS OR INFORMANTS, A RELATED PARTY (E.G., MINISTER, EMPLOYEE, CONTRIBUTOR, AFFILIATED ORGANIZATION), OR ANOTHER SERVICE DIVISION. THUS, THE SERVICE USUALLY HAS THE BURDEN OF OBTAINING INFORMATION NECESSARY TO DETERMINE PROPER TAX STATUS, BUT THE INFORMATION IS IN THE CUSTODY OF THE INDIVIDUAL OR INSTITUTION. OF COURSE, CHURCH SCHEME TAX PROTESTERS ATTEMPT TO TAKE FULL ADVANTAGE OF THE LAWS LIMITING SERVICE ACCESS TO CHURCH TAX INFORMATION.

NOW, LET ME DESCRIBE HOW THE SERVICE INQUIRIES ABOUT AND, IF NECESSARY, EXAMINES CHURCHES. CODE SECTION 7605(c), THE APPLICABLE REGULATIONS, AND THE IMPLEMENTING INTERNAL REVENUE MANUAL PROVISIONS SET THE RULES AND GUIDELINES. SECTION 7605(c) PROVIDES THAT THE SERVICE WILL NOT EXAMINE THE "BOOKS OF ACCOUNT" OF A CHURCH (OR CONVENTION OR ASSOCIATION OF CHURCHES) TO DETERMINE LIABILITY FOR UNRELATED BUSINESS INCOME TAX UNDER SECTION 511, UNLESS THE REGIONAL COMMISSIONER, THE HIGHEST RANKING TAX OFFICIAL IN A REGION, BELIEVES THE CHURCH IS ENGAGED IN UNRELATED BUSINESS AND NOTIFIES THE CHURCH IN ADVANCE OF EXAMINATION. IN ADDITION, SECTION 7605(c) LIMITS SERVICE EXAMINATIONS OF CHURCH "RELIGIOUS ACTIVITIES" TO THOSE NECESSARY TO DETERMINE WHETHER THE ORGANIZATION

IS A "CHURCH OR CONVENTION OR ASSOCIATION OF CHURCHES" WITHIN THE INTENT OF THE CODE. FINALLY, THE PROVISION LIMITS SERVICE EXAMINATIONS OF CHURCH "BOOKS OF ACCOUNT" TO THOSE NECESSARY TO DETERMINE TAX LIABILITY UNDER THE CODE.

IN ADOPTING REGULATIONS TO IMPLEMENT SECTION 7605(c), THE SERVICE WAS VERY SENSITIVE TO THE CONSTITUTIONAL ISSUES AT STAKE AND CAREFULLY CONSIDERED THE COMMENTS OF THE INTERESTED RELIGIOUS COMMUNITY. AS A RESULT, THE REGULATIONS CONTAIN MORE RESTRICTIONS THAN SECTION 7605(c) REQUIRES. THE REGULATIONS NOT ONLY IMPLEMENTED THE STATUTE'S NOTICE AND APPROVAL RULES FOR UNRELATED BUSINESS EXAMINATIONS OF "BOOKS OF ACCOUNT" BUT ALSO LIMITED THE SCOPE OF ALL CHURCH EXAMINATIONS. SIGNIFICANTLY, THE SECTION 7605(c) PROTECTIONS ARE TRIGGERED BY A CLAIM THAT IS NOT PATENTLY FRIVOLOUS BY AN ORGANIZATION THAT IT IS A CHURCH. THE REGULATIONS ATTEMPT TO MINIMIZE SERVICE CONTACTS WITH CHURCHES TO THE BAREST EXTENT NECESSARY TO ENSURE COMPLIANCE WITH TAX LAWS.

SECTION 301.7605-1(c) OF THE REGULATIONS REQUIRES THE SERVICE TO ATTEMPT TO RESOLVE TAX QUESTIONS ABOUT ORGANIZATIONS CLAIMING TO BE CHURCHES WITHOUT RESORTING TO FORMAL EXAMINATION IF AT ALL POSSIBLE. THE REGULATIONS REQUIRE THAT IN ITS PRE-EXAMINATION INQUIRY, THE SERVICE MAKE AT LEAST TWO WRITTEN REQUESTS FOR THE NECESSARY INFORMATION BEFORE INITIATING A FORMAL CHURCH EXAMINATION. A KEY DISTRICT EMPLOYEE PLANS AND EXEMPT ORGANIZATIONS DIVISION (FIELD OFFICE) INITIATES PRE-EXAMINATIONS OF CHURCHES BASED ON

INFORMATION RAISING QUESTIONS ABOUT POSSIBLE NONCOMPLIANCE WITH THE INTERNAL REVENUE CODE. INFORMATION ABOUT SPECIFIC EXEMPT ORGANIZATIONS COMES FROM INTERNAL SOURCES, THE CRIMINAL INVESTIGATION DIVISION OR EXAMINATION DIVISION, THE ORGANIZATION'S RETURN, A RELATED PARTY'S RETURN, OR AN INFORMANT OR COMPLAINANT. ALTHOUGH THE PROCEDURES FOR HANDLING INFORMATION ITEMS MAY VARY SLIGHTLY FROM DISTRICT TO DISTRICT, USUALLY THE CHIEF, TECHNICAL STAFF OR RETURNS PROGRAM MANAGER (RPM) IS THE OFFICIAL PRIMARILY RESPONSIBLE FOR DETERMINING WHETHER INFORMATION ABOUT A SPECIFIC ORGANIZATION WARRANTS ACTION. IF THE INFORMATION INDICATES EXAMINATION POTENTIAL THE ORGANIZATION'S RETURN, IF IT FILED ONE, WILL BE ASSIGNED TO AN EXEMPT ORGANIZATIONS EXAMINATION GROUP FOR REVIEW. IF THE ORGANIZATION DID NOT FILE A RETURN, THE INFORMATION WILL BE SENT TO THE EXEMPT ORGANIZATIONS EXAMINATION GROUP TO CONSIDER INITIATING PRE-EXAMINATION PROCEDURES.

UNDER THE PRE-EXAMINATION PROCEDURES OF THE INTERNAL REVENUE MANUAL, THE SERVICE WRITES TO THE ORGANIZATION REQUESTING INFORMATION NECESSARY TO CLARIFY ITS TAX STATUS. THIS CORRESPONDENCE EXPLAINS THE PURPOSE OF OUR INQUIRY AND IDENTIFIES IT AS A SECTION 7605(c) INQUIRY. IT ALSO ADVISES THAT THE SERVICE MAY INSTITUTE AN EXAMINATYION OR PROPOSE AN ADVERSE DETERMINATION, IF THE ORGANIZATION DOES NOT SUPPLY INFORMATION SUFFICIENT TO CLARIFY ITS TAX STATUS. IF TO WRITTEN REQUESTS FAIL TO PRODUCE THE NECESSARY INFORMATION, THE DISTRICT DIRECTOR MAY SEEK APPROVAL OF AN EXAMINATION FROM THE REGIONAL COMMISSIONER.

ALTHOUGH THE STATUTE AND REGULATIONS REQUIRE A REGIONAL COMMISSIONER'S APPROVAL ONLY FOR UNRELATED BUSINESS EXAMINATIONS OF A CHURCH'S "BOOKS OF ACCOUNT", OUR PROCEDURES GO FURTHER AND REQUIRE THAT A REGIONAL COMMISSIONER MUST APPROVE ANY CHURCH EXAMINATION REGARDLESS OF SCOPE OR ISSUE: THE REGIONAL COMMISSIONER MAY NOT APPROVE AN EXAMINATION UNLESS HE "BELIEVES THAT SUCH EXAMINATION IS NECESSARY" BASED ON THE INFORMATION AT HAND. IN ADDITION, THE REGIONAL COMMISSIONER MAY NOT APPROVE AN EXAMINATION UNTIL THE SERVICE'S "REASONABLE ATTEMPTS", AT LEAST 2 WRITTEN REQUESTS, TO OBTAIN THE INFORMATION HAVE FAILED, AND THE REGIONAL COMMISSIONER HAS CONCLUDED THAT THE "INFORMATION CANNOT BE FULLY OR SATISFACTORILY OBTAINED IN THAT MANNER." THUS, CHURCH EXAMINATIONS ARE AUTHORIZED ONLY AFTER A CHURCH HAS REFUSED TO SUPPLY INFORMATION NECESSARY TO RESOLVE THE QUESTIONS ABOUT ITS TAX STATUS. LET ME EMPHASIZE THAT THE REGIONAL COMMISSIONER REVIEW AND APPROVAL PROCEDURE ENSURES THAT CHURCH EXAMINATIONS ARE NOT UNDERTAKEN LIGHTLY. COMPARED TO THE LARGE NUMBER OF INDIVIDUAL PROTESTER RETURNS IDENTIFIED WITH SHAM CHURCH SCHEMES, WE PRE-EXAMINE AND EXAMINE RELATIVELY FEW CHURCHES. OVER THE PAST THREE FISCAL YEARS, WE HAVE CLOSED 199 CHURCH CASES OF WHICH 116 RESULTED IN EXAMINATIONS. A SUBSTANTIAL PORTION OF OUR CHURCH INQUIRIES ARE INITIATED TO DETERMINE IF INDIVIDUALS ARE USING CHURCH STATUS TO AVOID THEIR INDIVIDUAL TAX LIABILITIES.

AFTER A REGIONAL COMMISSIONER APPROVES A CHURCH EXAMINATION, HE NOTIFIES THE ORGANIZATION IN WRITING. THAT CORRESPONDENCE ADVISES THE CHURCH THAT EXAMNINATION IS NECESSARY BECAUSE PRE-EXAMINATION ATTEMPTS TO RESOLVE QUESTIONS ABOUT THE CHURCH'S STATUS FAILED. THE REGIONAL COMMISSIONER'S NOTICE INFORMS THE CHURCH THAT THE RULES OF SECTION 7605(c) WILL GOVERN THE EXAMINATION. OF COURSE, THE FULL ADMINISTRATIVE AND JUDICIAL APPEAL RIGHTS AVAILABLE TO ALL TAXPAYERS APPLY IN ADDITION TO THE SECTION 7605(c) PROTECTIONS.

THE REGULATIONS ALSO LIMIT THE PERMISSIBLE SCOPE OF VARIOUS TYPES OF CHURCH EXAMINATIONS. FIRST, SECTION 301.7605-1(c)(2) PROVIDES THAT THE SERVICE MAY NOT EXAMINE THE "BOOKS OF ACCOUNT" OF A CHURCH EXCEPT FOR THESE PURPOSES:

1) TO DETERMINE INITIAL OR CONTINUING QUALIFICATION UNDER SECTION 501(c)(3);
2) TO DETERMINE WHETHER THE ORGANIZATION QUALIFIES AS ONE, CONTRIBUTIONS TO WHICH ARE DEDUCTIBLE UNDER SECTIONS 170, 545, 642, 2055, 2106, OR 2522;
3) TO OBTAIN INFORMATION VERIFYING PAYMENTS MADE BY THE ORGANIZATION (CHURCH) TO ANOTHER PERSON IN DETERMINING THE TAX LIABILITY OF THE RECIPIENT:
4) TO DETERMINE THE TAX LIABILITY OF THE ORGANIZATION UNDER THE CODE.

SECOND, SECTION 301.7605-1(c)(3) PROVIDES THAT THE SERVICE MAY NOT EXAMINE THE "RELIGIOUS ACTIVITIES" OF A CHURCH EXCEPT FOR THESE PURPOSES:

1) TO DETERMINE INITIAL OR CONTINUING QUALIFICATION UNDER SECTION 501(c)(3);
2) TO DETERMINE WHETHER THE ORGANIZATION QUALIFIES AS ONE, CONTRIBUTIONS TO WHICH ARE DEDUCTIBLE UNDER SECTIONS 170, 545, 642, 2055, 2106, OR 2522;
3) TO DETERMINE WHETHER THE ORGANIZATION IS A CHURCH OR CONVENTION OR ASSOCIATION OF CHURCHES SUBJECT TO THE PROVISIONS OF PART III OF SUBCHAPTER F OF CHAPTER 1 (UNRELATED BUSINESS INCOME TAX).

AS MENTIONED, ALTHOUGH THE REGULATIONS DO NOT REQUIRE REGIONAL COMMISSIONER APPROVAL AND NOTIFICATION FOR EXAMINATIONS OF "RELIGIOUS ACTIVITIES", THE SERVICE ADMINISTRATIVE RULES NEVERTHELESS REQUIRE SUCH APPROVAL AND NOTIFICATION. THIS EXTRA REQUIREMENT WAS SELF-IMPOSED IN VIEW OF THE SENSITIVITY OF CHURCH EXAMINATIONS.

GENERALLY SPEAKING, THESE ARE THE RULES GOVERNING OUR TREATMENT OF CHURCHES AND CHURCH EXAMINATIONS. THEY HAVE EVOLVED OVER TIME IN RESPONSE TO THE NEEDS OF BOTH THE GOVERNMENT AND THE TAXPAYER. THEY ARE STATUTORILY BASED AND JUDICIALLY APPROVED.

HOWEVER, WE WELCOME SUGGESTIONS ABOUT HOW WE MIGHT IMPROVE OUR PROCEDURES TO DISCOURAGE CHURCH TAX SCHEMES AND, AT THE SAME TIME, SPARE NON-PROTESTERS FROM UNREASONABLE INQUIRIES.

Commissioner **Egger**. We in Internal Revenue are keenly aware of the sensitive nature of the church and State relationship. We recognize the importance of the first amendment's constitutional mandate that Government interference with the free exercise of religion be limited to cases of compelling Government interest and be restricted to the extent necessary to enforce that interest. Very specific Federal statutes and case law prescribe Internal Revenue Service treatment of churches and related parties to guarantee compliance with this constitutional mandate. In my testimony, I will outline the rules governing Service examinations of churches, and explain how those examinations are conducted.

In addition, I will comment on the procedures voluntarily instituted by the Service which we feel go well beyond the minimum legal requirements in an effort to comply with the spirit of the law.

First, let me state the obvious. The Internal Revenue Service has a clear-cut obligation to enforce the Federal tax law with respect to all taxpayers, including churches in appropriate circumstances, and those organizations claiming to be churches. The courts have consistently upheld our authority to examine such organizations. Those claiming the legal benefits flowing from church status naturally must comply with the law providing those special benefits. It is only fair and equitable to all other taxpayers.

The Service restricts its church inquiries to matters germane to the determination of the proper tax status of churches and related parties. Contrary to some claims, we do not examine churches to pass on the legitimacy or the merits of individual religious belief.

No court reviewing our denial of exempt church status to an organization has ever found that the Service based its decision on a value judgment about the organization's beliefs. Judgments by us regarding the nature of religious belief are both repugnant and unconstitutional. Current law and our administrative procedures expressly forbid them.

We explicitly instruct our employees that such considerations play absolutely no part in a determination of any taxpayer's liabilities. We have recognized, for example, the exempt church status of organizations that are diverse in belief and practices as a fundamentalist Christian commune, a Hindu ashram, a group of secular humanists, and a sect worshipping pagan deities and practicing witchcraft.

However, as you know, some individuals attempt to avoid their individual income tax liabilities by setting up sham churches to claim the various tax benefits, deductions, and exclusions available to bona fide churches and ministers. These tax avoidance and evasion schemes are just another form of illegal activity that we generically label "illegal tax protest." We cannot tolerate this form of tax fraud. We have an extensive and well publicized illegal tax protester program to identify, examine, and, if appropriate, prosecute taxpayers that fraudulently claim tax exempt church status and its ancillary benefits. The well known schemes—the mail order ministries, the vow of poverty, assignment of income, et cetera—are described in our Internal Revenue Manual.

We intend to pursue these and all other future church schemes as vigorously as legally possible. This or any other kind of tax fraud hurts all taxpayers. Tax protester, who shirk their tax responsibilities erode the revenue base. But, more importantly, they undermine the honest citizen's confidence in the system.

Historically, the Internal Revenue Code has exempted nonprofit churches and religious organizations from Federal income tax. This exemption fosters the proper constitutional separation between church and State and recognizes the charitable nature of such organizations. The current provision, section 501(c)(3), exempts organizations organized and operated exclusively for religious purposes. Of course, this includes churches although they are not specifically mentioned.

Section 501(c)(3) carefully conditions exemption to guarantee that religious rather than private, selfish interests are being furthered. Thus, exemption is denied when the organization's net earnings inure to the benefit of private shareholders or individuals, if the organization engages in political campaigns on behalf of candidates, or if the organization engages in substantial amounts of lobbying or legislative action.

Churches are also liable for tax on income from unrelated business under section 511. To determine a church's proper tax status, the Service reviews all information bearing on whether the church meets the conditions of the applicable code sections.

Code section 7602, as amplified by sections 6001, 6033, 7605, and the underlying regulations, empowers the Service to obtain the necessary information from churches. Section 7605(c) sets out very specific parameters for church examinations.

It is important here to note that section 7605(c) was enacted in 1969 to clarify how the Service should conduct examinations of church records and affairs. This section was not enacted, as some critics argue, to remove the long-standing authority of the Service to inquire into the tax status of organizations claiming to be churches. Attempts to gain judicial recognition of these critics' interpretation have consistently failed. And here I should emphasize why we must ask churches for information.

Under section 508(a), churches need not apply to the Service for formal recognition of tax exempt status. Section 6033 exempts churches from the requirement that they file information returns, although they are not excused from filing tax returns on their unrelated business. Consequently, we have an initial record of only those churches that voluntarily apply for and formalize their tax exempt status.

We learn about the other churches collaterally from information provided by complainants, by informants, and by related parties—for example, minister, employee, contributor, affiliated organizations and so on; or perhaps from another division of the Internal Revenue Service.

Thus, the Service usually has the burden of obtaining information necessary to determine proper tax status. But the information is in the custody of the individual or the institution. Of course, church scheme tax protesters attempt to take full advantage of the laws limiting Service access to church tax information.

Now let me describe briefly how the Service inquires about, and, if necessary, examines churches. Code section 7605(c), the applicable regulations, and the implementing Internal Revenue Manual provisions set the rules and the guidelines. Section 7605(c) provides that the Service will not examine the books of account of a church or convention or association of the churches to determine liability for unrelated business income tax under section 511 unless the regional commissioner, the highest ranking tax official in a region, believes the church is engaged in an unrelated business, and notifies the church in advance of examination.

In addition, 7605(c) limits Service examinations of church religious activities to those necessary to determine whether the organization is a church or convention or association of churches within the intent of the code. Finally, the provision limits Service examinations of church books of account to those necessary to determine tax liability under the code.

In adopting regulations to implement this code section, the Service was very sensitive to the constitutional issues at stake, and carefully considered the comments of the interested religious community. As a result, the regulations contain more restrictions than section 7605 itself requires. The regulations not only implemented the statute's notice and approval rules for unrelated business examinations of books of account, but also limited the scope of all church examinations. Significantly, the section 7605 protections are triggered by a claim that is not patently frivolous by an organization that it is a church. The regulations attempt to minimize Service contact with churches to the barest extent necessary to insure compliance of tax laws.

Mr. Chairman, my written statement contains a fairly detailed description of the rules and procedures that we follow in the examination of churches, so I will not try to cover that in the oral presentation here.

Therefore, let me simply conclude by saying that these rules have evolved over time in response to the needs of both the Government and the taxpayers. They are statutorily based and judicially approved. However, we welcome suggestions about how we might improve our procedures to discourage church tax schemes and at the same time spare nonprotesters from unreasonable inquiries. The objectives of the legislation are not dissimilar from our own.

I will stop here and ask Mr. Pearlman to go forward.

STATEMENT OF RONALD A. PEARLMAN, DEPUTY ASSISTANT SECRETARY FOR TAX POLICY, DEPARTMENT OF THE TREASURY, WASHINGTON, D.C.

Senator **Grassley**. I will have you testify, Mr. Pearlman, and then I will ask questions of both of you.

Mr. **Pearlman**. Thank you, Mr. Chairman. We appreciate being here this morning to offer the administration's views on Senate bill 1262, the Church Audit Procedures Act of 1983.

Let me, before I get into the details of the bill, emphasize at the outset, Mr. Chairman, that the administration shares your concerns about the adequacy of safeguards on Internal Revenue Service church audit procedures, which were designed to protect the first amendment freedoms of religious organizations, and enforcement of the Federal tax laws applicable to all tax exempt organizations.

We support the basic objectives of Senate bill 1262. We also share your concerns, however, that any legislation in this area not make changes which insulate tax protesters and sham churches from legitimate Internal Revenue Service investigations. Therefore, while we are supportive of many of the provisions of S. 1262, we want to suggest a number of revisions designed to avoid encouraging the growth of the tax protester movement.

We think the decision to conduct these hearings serves both the legislative and administrative process. Prior to the introduction of Senate bill 1262, we had heard no complaints from any religious organization concerning current audit procedures. These hearings will enable us to evaluate the current procedures. We hope to meet with representatives of the religious organizations who are testifying here today and other interested religious organizations to hear their concerns and seek to develop mutually acceptable solutions to the problems that they may have with current procedures.

Under current law and under Treasury regulations which expand current law, the IRS may begin an investigation of a church only if it believes the church is engaged in an unrelated business which would produce taxable income or is no longer tax exempt. It must give the church or the taxpayer claiming to be a church two written requests for information prior to the initiation of the formal examination of the books of account of the church.

Only if no satisfactory response is made to these requests after a 30-day notice may the Service begin an actual examination.

In analyzing these current procedures and the proposed changes, it is important to recognize Service's serious problems which result from tax protesters' efforts to shelter their income by creating organizations purporting to be churches. The predominate number of so-called church audits involve these types of taxpayers.

In a September 7 decision of the U.S. Tax Court, the court said, "our tolerance for taxpayers who establish churches solely for tax avoidance purposes is reaching a breaking point." Therefore, our efforts, and we hope the efforts of the subcommittee, will be to make sure that Senate bill 1262 does not add fuel to the tax protester movement fire.

Now I would like to review the key provisions of Senate bill 1262, and offer our specific comments.

First, 1262 would establish a new evidentiary standard for which the Service could commence an investigation. It would require the Service to possess evidence that the church is engaged in an unrelated business or is not tax exempt. We think it is appropriate to require the Service to possess facts or information supporting its determination that an investigation is necessary before it seeks to examine the records in the possession of the church. And we are happy to work with the subcommittee in seeking to develop an appropriate statutory standard. We cannot support application of any evidentiary standard or information threshold limiting the Service's access to third party information or records, such as bank accounts, stock records, or real estate records. Any such restriction would mean the Service would not be able to review any records until it possessed information which it frequently could not obtain until it reviewed those records.

Such a restriction would put the Service in a Catch-22 position, and would undoubtedly result in investigations being started on the basis of third-party allegations, such as from disgruntled church employees. The use of this type of information, which is much less reliable than third-party records, is likely to lead to unnecessary investigations and prolong unnecessarily these investigations.

Second, Senate bill 1262 would expand current law notification procedures. Our first comments relate to the timing of the notice procedures contained in Senate bill 1262. Present law notice procedures apply only to the examination of church books of account. The proposed procedures would apply to any church records or any church activities.

We are troubled by the use of the undefined term "church records," as it may be a significant expansion of the types of records subject to these special rules. It could, on the one hand, be argued that the term covers only documents in the church's possession, such as correspondence, organizational documents, minutes, or other records kept of meetings of church officials. We are concerned, however, that it could be argued that the term would apply to third-party records, including bank records, which have never before been subject to church audit guidelines. As I have noted above, the IRS relies on its ability to examine these third-party records to resolve questions about the tax liabilities of organizations which claim the church status without resorting to a formal examination, if at all possible.

In many instances, the IRS is able to determine that no further investigation of the church is necessary based on a preliminary examination of third-party records. Imposition of an evidentiary guideline such as contained in S. 1262, if applied to third-party records, would materially impede such preliminary investigations. It would increase the frequency of IRS contacts with churches. Therefore, we recommend that prior to any direct examination of books and records possessed by the church, the IRS must be required to notify the church. However, no notification should be required prior to an investigation of third-party information.

The second item that I would like to comment on in connection with the notice requirements is the contents of the notice. Under the proposed notice requirements, before beginning any investigation for the purpose of determining unrelated business income or exempt status, the IRS will be required to notify the church in writing that an examination is under consideration.

The first notice would be required to include a list of Internal Revenue Code provisions authorizing the investigation, an explanation of the church's constitutional and procedural rights, a list of the concerns giving rise to the investigation, an explanation of the relevant legal and factual issues, a description of all the evidence discovered to date, and an offer of a preexamination conference. A second written notice would be required to be sent before any examination could occur, provided that a conference to discuss the allegations had been held, and provided that the Internal Revenue Service regional council has concurred with the regional commissioner that the investigation should proceed.

Treasury Department supports several of these proposed changes to the content of the Service's audit notice. Under current procedures, the Internal Revenue Service manual's pattern language for preexamination contacts states that the Service intends to investigate the church's tax status; it describes the code sections authorizing its actions; and it describes the consequence of a failure to respond and the church's judicial appeal rights.

We agree that these current notice guidelines would be improved by the addition of some of the requirements proposed by Senate bill 1262. For example, we think a brief statement of the reasons for the Internal Revenue Service's inquiry and a full explanation of the taxpayer's administrative rights would be appropriate.

We also have no objection to the requirements that the second notice describe the church records and the actions which the IRS seeks to examine.

There are other provisions, however, of the notice proposal which raise matters of serious concern. First, with respect to the requirement that the organization receive a description of all evidence discovered prior to the examination, we are concerned that such advance notice would serve only to prevent the Service from ascertaining the true facts. For example, the notice could offer unscrupulous taxpayers the opportunity to manufacture evidence or hide or destroy related or undiscovered evidence or to intimidate Government witnesses, all of which we have found has occurred in tax protester cases.

In addition, we fear that the proposed requirement for an explanation of the legal and factual issues relevant to the case may create a judicial defense, which is particularly likely to be abused in the tax protester cases whenever a case does not develop precisely as the IRS had anticipated in the initial explanation.

Here again we would emphasize the Service's continuing compliance problems with tax protests involving churches. As these protesters become better organized and more sophisticated, they will take the offensive in litigation with the Government. The creation by statute of unnecessarily complicated audit procedures will be seized upon, we are concerned, by these protesters engaged in mail order ministries and other religious tax shelters, and used by them as frivolous defenses in litigation designed only to harass the IRS and to delay legitimate investigations.

We are sure that the members of this subcommittee and supporters of this legislation share our concern and understand why we seek to limit some of these notice requirements.

Senate bill 1262 would also require that the Internal Revenue Service's initial notice offer the church a conference to discuss these allegations. The Treasury Department supports the concept of such a preexamination conference, so long as it does not impede unnecessarily the progress of the investigation.

Preexamination conferences frequently are conducted in business audits, and we would anticipate, Mr. Chairman, that a similar procedure could be developed for church audits.

Senate bill 1262 requires that before any investigation of a church, the IRS regional council must confer with the IRS regional commissioner before the investigation begins. As the Commissioner has indicated, the regional commissioner is the top tax official within a region within the country. We think it is unnecessary to require formal approval of an audit by both the regional council and the regional commissioner in abrogation of the IRS' current internal lines of authority. This is not to say, Mr. Chairman, that legal advice is not given to the regional commissioner in connection with his determination as to opening examinations. We are concerned simply by the necessity of a personal review by an additional official within that region.

Senate bill 1262 also requires that all church audits be completed, and a decision made on the merits within 365 days of the date of the first notice of investigation. The Treasury Department supports the concept of placing a time limit on the period within which the Service must complete a formal investigation of the books and records in a church's possession. We do not support, however, the 1-year period proposed by the bill because it is unlikely that any complicated examination could be completed in a 365-day period. Establishing too short a period would force the IRS to issue statutory notices of deficiency or proposed revocations of exempt status before completing the full investigation in any case where the period was coming to a close. We doubt that the churches or church groups supporting this legislation have considered this consequence of imposing an overly short time deadline for completing the church audit. And we are confident that we can work with the subcommittee and supporters of this bill to develop a reasonable time limitation on the completion of any examination of the church's books and records.

Senate bill 1262 requires that any tax on a church would have to be assessed within 3 years after such tax became due, and before the expiration of 3 years after the date on which any part of such tax was paid. The Treasury Department generally supports the concept that some statutory limit similar to a statute of limitations should be established on the number of years subject to retroactive challenge by the Internal Revenue Service in any civil examination of a church.

However, we are disturbed that Senate bill 1262 neither allows sufficient opportunity for audits commenced late in the 3-year period to be completed, nor does it provide for any extension of the proposed 3-year limitations period in the case of fraud or other willful attempts to avoid tax. We do not think that any taxpayer should be able to claim a shortened statute of limitations when fraud or tax evasion is at issue.

Finally, Senate bill 1262 would create an exception for churches from the normal rules governing suits for declaratory judgments to resolve issues of tax-exempt status. Under current law, a court may issue a declaratory judgment only after determining that an organization has exhausted its administrative remedies within the Internal Revenue Service.

The change proposed by the bill would permit a church to seek a declaratory judgment in any matter involving revocation or denial of exempt status merely by demonstrating that he had been notified of an IRS examination. In addition, the bill would permit a church to bring a civil action in Federal district court to enjoin the IRS from further engaging in any audit activity which the church claims is in violation of the new church audit procedures.

We are sympathetic with the churches' concerns that they have some judicial recourse to the court in any case where the IRS has violated church audit procedures. For this reason, we recommend that Senate bill 1262 be amended to provide that proof of such violation would be admissible as a defense in any summons action brought against a church by the Internal Revenue Service to compel production of books and records. Again, we would hope to work with the subcommittee in drafting this provision to make sure that ministerial variation from the statutory procedure would not irrevocably taint the IRS' case in such a summons action.

Our concerns about preventing violations of the church audit procedures do not, however, lead us to support the specific amendments dealing with the declaratory judgments and injunctive relief. We believe these proposals are inconsistent with the independence from judicial interference which the Congress traditionally has accorded IRS audit proceedings.

Once again, we would caution the subcommittee about the litigiousness of tax protesters. A popular tactic for delay and harassment used by these protesters is the frivolous lawsuit for injunctive relief, which at present can be easily resisted because of the anti-injunction provisions of the code. Without that, these protesters would use and abuse both the declaratory judgment and injunctive relief provision and thereby delay perhaps for years audits that might have been terminated had the normal process not been interrupted.

In summary, Mr. Chairman, the Treasury Department supports both the general purposes and subject to certain changes that we suggested many of the provisions of Senate bill 1262. The changes we have suggested have been designed to correct what we believe are legitimate problems which may have been experienced with the IRS' current church audit procedures without simultaneously inhibiting the Service's efforts to prevent organizations from using church status as a shield for taxable activities.

We emphasize again that we are seriously concerned about the recent proliferation of tax shelters disguised as religious organizations. We assume that our concerns are shared by the members of this subcommittee as well as the religious organizations supporting this legislation.

We would, therefore, hope that we can work with this subcommittee and with the supporters of the legislation to draft rules which further the bill's stated purpose of improving and clarifying current audit practices, but which do not cause the IRS to resort to counterproductive audit procedures which violate the concept of encouraging reasonable communication between the Service and taxpayers.

We would emphasize in conclusion that both the Treasury Department and the IRS have always assumed that existing procedures governing church audits adequately protect churches from unwarranted examinations. We, therefore, are troubled by the apparent belief that the IRS currently is using its powers to audit churches unnecessarily. We would be most interested in meeting with any religious organization or group to discuss any problems which may exist either with existing procedures or, if S. 1262 is enacted, with the rules established after passage of this legislation.

Mr. Chairman, we appreciate the opportunity of presenting our comments to you this morning. I would be happy to try to join the Commissioner in answering any questions you have.

Thank you.

[The prepared statement of Mr. Pearlman follows:]

For Release Upon Delivery
Expected at 9:30 a.m. EDT
September 30, 1983

STATEMENT OF
RONALD A. PEARLMAN
DEPUTY ASSISTANT SECRETARY (TAX POLICY)
DEPARTMENT OF THE TREASURY
BEFORE THE SUBCOMMITTEE ON OVERSIGHT
OF THE INTERNAL REVENUE SERVICE
OF THE
SENATE COMMITTEE ON FINANCE

Mr. Chairman and Members of the Subcommittee:

I am pleased to present the views of the Department of the Treasury on S. 1262, the "Church Audit Procedures Act of 1983."

I would like to emphasize at the outset of my testimony that the Administration shares your concerns about the adequacy of the safeguards on Internal Revenue Service church audit procedures, which were designed to protect the First Amendment freedoms of religious organizations. We certainly agree that audit procedures should strike an appropriate balance between deference to these Constitutional protections and enforcement of the federal tax laws applicable to tax-exempt organizations. Accordingly, we support the basic objectives of S. 1262.

We appreciate and share your concerns that in amending the existing audit procedures, we do not inadvertently make changes which would serve only to insulate tax protesters and sham churches from legitimate IRS investigations. Therefore, although we support many of the provisions of S. 1262, we wish to suggest modifications (which are outlined below) to a number of these provisions, to avoid encouraging the growth of the tax protestor movement.

We also want to stress our appreciation for the efforts of this Subcommittee in focussing attention on problems that may have arisen with respect to the application of the current church audit procedures. Prior to the introduction of S. 1262, we had not heard any complaints from religious organizations concerning these procedures. We therefore plan to review carefully the testimony presented at this hearing by the individuals and organizations supporting this bill. We also look forward to meeting with representatives of these organizations in an effort to develop solutions to the administrative problems they may have with the IRS's examination and appeal procedures.

Current Procedures Governing Audits of Religious Organizations

The existing rules governing church audit procedures were added to the Internal Revenue Code in 1969, in order to protect churches from unnecessary tax audits or other governmental intrusion into internal financial matters of churches. Treasury's regulations under Code section 7605(c) expand these statutory protections.

In brief, the IRS may begin an investigation of any church only on the basis of a belief that the church is engaging in an unrelated business (the income of which would be taxable under Code section 511) or is no longer tax exempt. Prior to any formal examination of a church's "books of account," the IRS must make at least two written requests to the church for the information it deems necessary to its determination. Only if no satisfactory response is made may an actual examination take place, and then the IRS must give the church at least 30 days notice prior to the actual examination.

In analyzing both current church audit practices and any proposed revisions to these procedures, it is important to recognize that the IRS's primary problems in administering the tax laws applicable to churches (and the predominate number of audits) involve efforts on the part of tax protestors to shelter their incomes by creating organizations purporting to be churches. We concur heartily with the Tax Court's statement this month in its most recent opinion dealing with religious tax shelters, that "our tolerance for taxpayers who establish churches solely for tax avoidance purposes is reaching a breaking point." (Miedaner v. Commissioner, 81 T.C. No. 21 (September 7, 1983).) Therefore, in drafting any proposals to change existing procedures, it is crucial to distinguish between legitimate criticisms of the IRS's investigatory procedures and amendments which would operate to impede examinations, generate litigation, and promote the growth of the tax protestor movement.

Proposed Legislation

The key features of S. 1262 are outlined and analyzed below.

Evidentiary Standard

S. 1262 would create a new prerequisite for commencing investigations, requiring the IRS to "possess evidence" that the church is engaging in unrelated business or is no longer exempt. The Treasury Department supports the requirement that the IRS possess facts or information supporting its belief that an investigation is necessary before it notifies any church that it requires access to church records. We would be happy to work with the Subcommittee to develop a statutory description of such a factual or informational prerequisite to commencement of any formal audit.

However, the Treasury Department cannot support the application of the standard proposed by S. 1262, or any other threshhold requirement, to limit the IRS's access to third party records, such as bank accounts, or stock transfer or real estate records. Such an overbroad application would be likely to place the IRS in the incongruous position of being unable to investigate any records relating to church affairs until it possessed information (which frequently could be obtained only from those records) establishing that an audit was necessary.

The probable effect of an overbroad threshhold requirement would be to require the IRS to commence investigations on the basis of third party allegations, such as from disgruntled church employees. This is a radical change from traditional audit procedures, which depend in large part upon reliable data from third-party recordkeepers, and upon direct contacts between the IRS and taxpayers. We strongly advise against enactment of any rule that would force the IRS to rely upon vague allegations by third party informers. The use of such hearsay is not likely to decrease the frequency of church audits, but instead is likely to prolong investigations that might have been settled much earlier simply by an examination of third party records.

By contrast, the investigation process would not be hindered if a new threshhold requirement along the lines of the one proposed by S. 1262 were adopted, provided it is applied only to church books and records. Under this modified rule, the IRS would commence a formal investigation of records possessed by the church itself only in those cases where it has found information from other sources (including from third party records) that the church is not complying with the unrelated business income tax or tax exemption provisions.

Notice Requirements: Timing of the Notice

S. 1262 would establish much more elaborate notification procedures applicable to any investigation of a church. Present law notice procedures apply only to examinations of church books of account. The proposed procedures would apply to any church records or church activities. Here again we are troubled by the use of the undefined term "church records" as a potentially significant expansion of the types of records subject to these special church audit rules. It could be argued that the term covers only such documents in the church's possession as church correspondence, organizational documents, or minutes or other records kept of meetings of church officials. It also could be argued, however, that the term would apply to third party records (including bank records), which have never before been subject to the church audit guidelines. As we explained above, the IRS relies on its ability to examine such records to resolve questions about the tax liabilities of organizations which claim church status without resorting to formal examination if at all possible. In many instances, the IRS has decided against further investigation of a church on the basis of a preliminary examination of third party records. Imposition of new audit guidelines would materially impede such preliminary investigations, and certainly would increase the frequency of IRS contacts with churches. Therefore, we recommend that prior to any direct examination of books and records possessed by the the church itself, the IRS must be required to notify the church. However, no notification would be made prior to an investigation of third party information. (We note that this distinction is similar to the one which we made above with respect to the facts and information prerequisite.)

Notice Requirements: Contents of the Notice

Under the proposed notice requirements, before beginning any investigation for the purpose of determining unrelated business income or exempt status, the IRS would be required to notify the church in writing that an examination is under consideration.

This first written notice would be required to include: (1) a list of the Internal Revenue Code provisions authorizing the investigation; (2) an explanation of the church's Constitutional and procedural rights; (3) a list of the concerns giving rise to the investigation; (4) an explanation of the legal and factual issues relevant to the case; (5) a description of all the evidence discovered to date; and (6) an offer of a pre-examination conference with the IRS to discuss all facts, evidence and issues relevant to the investigation. A second written notice would be required to be sent before any examination of church records or activities can occur, provided that (1) a conference to discuss the allegations has been held with the church (if one is requested), and (2) the IRS Regional Counsel has concurred with the IRS Regional Commissioner that the investigation should proceed. This second notice must describe all of the church records and activities that the IRS seeks to examine.

The Treasury Department supports several of these proposed changes to the content of the IRS's audit notices. Under current procedures, the Internal Revenue Manual's pattern language for pre-examination contacts states (i) the IRS's intention to investigate the church's tax status, (ii) the Code sections authorizing the IRS action, (iii) the consequences of a failure to respond, and (iv) the church's judicial appeal rights. We agree that these existing notice guidelines would be improved by the addition of some of the requirements proposed by S. 1262, such as a brief statement of the reasons for the IRS's inquiry, and a fuller explanation of the taxpayer's administrative rights. We also have no objection to the requirements that the second notice describe the church records and actions which the IRS seeks to examine. We would note, however, that a requirement of an overly detailed description presents an obvious practical problem in that it would be difficult in advance of an actual examination of the church records for the IRS to describe with any specificity the information which it expects to find during such examination.

There are other provisions of the notice proposal which raise matters of serious concern. First, with respect to the requirement that the organization receive a description of all evidence discovered prior to the examination, we are concerned that such advance notice would serve only to prevent the IRS from ascertaining the true facts. For example, the notice could offer unscrupulous taxpayers the opportunity to manufacture evidence, to hide or destroy related or undiscovered evidence, or to intimidate government witnesses. In addition, we fear that the proposed requirement for an explanation of "the legal and factual issues relevant to the case," may create a judicial defense which is particularly likely to be abused in tax protestor cases, whenever a case does not develop as the IRS had anticipated in the initial explanation.

Here again we would emphasize the IRS's continuing compliance problems with tax protests involving churches. As these protestors become better organized and more sophisticated, they frequently take the offensive in litigation with the government. The creation by statute of unnecessarily complicated audit procedures undoubtedly will be seized upon by protestors engaged in mail-order ministries and other "religious" tax shelters, and used by them as frivolous defenses in litigation designed only to harass the IRS and to delay legitimate investigations. We are sure that the members of this Subcommittee and the supporters of this legislation share our concerns and understand why we seek to limit some of the notice requirements proposed by S. 1262.

Pre-examination Conference

As noted above, S. 1262 would require that the IRS's initial notice of examination of church records or activities must offer the church a conference to discuss the allegations. If a conference is requested, it must be held before a formal examination of the church's records can commence.

The Treasury Department supports the concept of such pre-examination conferences, so long as they do not impede unnecessarily the progress of the IRS's investigations. We would note that pre-examination conferences frequently are conducted with respect to business audits, and therefore we expect that similar procedures could be developed with respect to church audits.

Concurrence by Regional Counsel

S. 1262 also requires that before any investigation of church records can commence, the IRS Regional Counsel must concur with the IRS Regional Commissioner that such an investigation is warranted. Although we understand the importance of ensuring that the IRS carefully reviews its evidence before beginning a formal church investigation, we think it is unnecessary to require formal approval of an audit by both Regional Counsel and Regional Commissioner, in abrogation of the IRS's current internal lines of authority.

Time Limit on Completion of Audits

S. 1262 also requires that all church audits be completed, and a decision made on the merits, within 365 days of the date of the first notice of investigation. This one-year period may be extended only if the church refuses a "reasonable request for records" or initiates a judicial proceeding to challenge the investigation.

The Treasury Department supports the concept of placing a time limit on the period within which the IRS must complete a formal investigation of books and records in a church's possession. We do not support, however, the one-year period proposed by the bill, because it is unlikely that any complicated church audit could be completed within a 365-day period. Establishing too short a time limit easily could force the IRS to issue a statutory notice of deficiency without completing a full investigation in any case where the period was coming to a close and there existed a possibility of a tax deficiency. We doubt that the churches supporting this legislation have considered this consequence of imposing an overly short time deadline for completion of a church audit, and we are confident that we can work with the Subcommittee and the supporters of this bill to develop a reasonable time limitation on completion of any examination of books and records in the church's possession.

Special Statute of Limitations

S. 1262 requires that any tax on a church would have to be assessed "within 3 years after such tax became due and before the expiration of 3 years after the date on which any part of such tax was paid." This section of S. 1262 is confusingly drafted, but the proposed statute of limitations apparently would apply regardless of whether the church had filed a return, or had filed a fraudulent return.

The Treasury Department generally supports the concept that some statutory limit, similar to a statute of limitations, should be established on the number of years subject to retroactive challenge by the IRS in any civil examination of a church. We are sympathetic with the fact that churches currently cannot claim the protection of any statute of limitations, since churches are not required to file income tax returns except in cases where they owe tax on unrelated business income. However, we are disturbed that S. 1262 neither allows sufficient opportunity for audits commenced late in the three-year period to be completed, nor provides for any extension of the proposed three-year limitations period in the case of fraud or other willful attempts to avoid tax. We do not think that any taxpayer should be able to claim a shortened statute of limitations when fraud or tax evasion is at issue.

Declaratory Judgments

Finally, S. 1262 would create an exception for churches from the normal rules governing suits for declaratory judgments to resolve issues of tax-exempt status. Under current law, a court may issue a declaratory judgment only after determining that an organization has exhausted its administrative remedies within the IRS. An organization is not deemed to have exhausted its administrative remedies until either it has received and appealed a denial or revocation of its exempt status, or it has requested a determination as to its exempt status and has waited 270 days for an answer. The change proposed by S. 1262 would permit a church to seek a declaratory judgment in any matter involving revocation or denial of its exempt status merely by demonstrating that it has been notified of an IRS examination. In addition, the bill would permit a church to bring a civil action in federal district court to enjoin the IRS from further engaging in any audit activity which the church claims is in violation of the new church audit procedures.

We are sympathetic with the churches' concerns that they have some judicial recourse to the courts in any case where the IRS has violated church audit procedures. For this reason, we recommend that S. 1262 be amended to provide that proof of such violations would be admitted as a defense in any summons action brought against a church to compel production of books and records. We would hope to work with the Subcommittee in drafting this provision, in order to ensure that ministerial variations from the statutory procedures would not irrevocably taint the IRS's case in such a summons action.

Our concerns about preventing violations of the church audit procedures do not, however, lead us to support the specific amendments to the declaratory judgment and injunctive relief provisions proposed by S. 1262. We believe that these proposals are inconsistent with the independence from judicial interference which the Congress traditionally has accorded IRS audit proceedings. Once again we would caution the Subcommittee about the litigiousness of tax protestors. A popular tactic for delay and harassment used by protestors is the frivolous suit for injunctive relif, which at present is easily resisted by the anti-injunction provisions of Code section 7421(a). Without doubt these protestors would use and abuse both the declaratory judgment and injunctive relief provisions, and thereby delay, possibly for years, audits that might have been terminated had the normal audit process not been interrupted. In addition, in our judgment these provisions would burden the court system with cases which could have been resolved administratively if the law, as it presently does, encouraged cooperation and discussion between the IRS and churches.

Summary of Treasury Position

The Treasury Department supports both the general purposes and (subject to suggested changes) many of the provisions of S. 1262. The changes which we have suggested have been designed to correct any legitimate problems which may have been experienced with the IRS's current church audit procedures, without simultaneously inhibiting the IRS's efforts to prevent organizations from using church status as a shield for taxable activities. We emphasize again that we are seriously concerned about the recent proliferation of tax shelters disguised as religious organizations. We assume that our concerns are shared by the members of this Subcommittee, as well as the religious organizations supporting this legislation. We would therefore hope that we can work with this Subcommittee and with the supporters of this legislation to draft new rules which further the bill's stated purpose of "improving and clarifying" existing audit practices, but which do not cause the IRS to resort to counterproductive audit procedures which violate the concept of encouraging reasonable communication between the IRS and taxpayers.

We would emphasize in conclusion that both the Treasury Department and the IRS have always assumed that the existing procedures governing church audits adequately protect churches from unwarranted examinations. We therefore are troubled by the apparent belief that the IRS currently is using its powers to audit churches unnecessarily. We would be most interested in meeting with any religious organization or group to discuss any problems which may exist either with existing procedures, or, if S. 1262 is enacted, with the rules established after passage of this legislation.

That concludes my prepared testimony. I would be happy to answer any questions you may have.

Senator **Grassley**. Well, first of all, I want to thank you for the recognition that members of this subcommittee and committee, and particularly Senator Dole and myself who in the past 2 years have been doing those things that have zeroed in on tax shelters because I think our goals are the same as yours, and I think the principal author in the House, Mickey Edwards, expressed that this morning as clearly as any one person could do it—I want to associate myself with your concerns. And my position would be the same as Mickey Edwards. That means that as we consider this legislation we have to look at the lines of the bill in detail and measure your concerns against what we are trying to solve, and see what we can come up with.

We owe you an opportunity to sit down and visit with us. I think, too, you have shown your willingness to cooperate with the groups on the outside who are concerned in the sense that you said you were willing to sit down with some of the very people who are in this room and others who maybe aren't here. I would encourage you to do that. And also I would like to have, if I can participate or my staff participate in those—I would like to tell you that I'm willing to devote what time it takes to come up with a good piece of legislation.

But I also want to thank the administration for its support of the objectives of this bill. That is a recent development, it's my understanding. And I appreciate it very much.

I have several questions, and I would invite each of you to respond even though I direct some questions to Mr. Egger and some to Mr. Pearlman. I would ask you to respond as either of you see fit.

I would like to ask Mr. Egger—how many churches are under audit for questions about their unrelated business income or revocation of their tax exempt status?

Commissioner Egger. I'm not sure I can give you the precise breakout as to the——

Senator **Grassley**. Maybe you could do that in writing.

Commissioner Egger. I can.

Commissioner **Egger**. Let me say this, though. That in the last 3 fiscal years we have preexamined 199 organizations that either were or claimed to be churches. Out of the 199, we only went forward with examination of 116 of those. That's because the information that was supplied in our preexamination eliminated the necessity for examination of the others.

Now out of the balance of 116 we had some 47 of them that had not furnished the information initially, but when we went forward with the examination—and this may well have been getting the information through summons and all the rest of it—we found that 47—again, there was no adverse decision with regard to those 47.

So out of the 199 initially, 83 of them, we had no need to go forward. And it's a good estimate on my part at least that had the 47 that declined to furnish the information initially done so, there is a high probability that we would not even have had to go forward with an examination of that group.

Of the remainder, the 19 cases that we closed with some kind of a change, had to do basically with such things as their social security or unemployment tax payments. Things of that kind. Out of the remaining 50, only 16 of them were revocation cases.

So as you can see, a great deal of the time we have information that on the face or on the surface of it appear to require further inquiry, and once we get the information that sort of obviates the necessity for anything further.

The cases where we have the problems are the cases where there is, in fact, a protester situation involved. And naturally, they are going to resist, and they do. And they delay and delay; give us a little bit of information; hold back some; and a little bit more. And, finally, we go for a summons and then that takes another 15 months by the time we get through the courts on that.

So those are the ones that are the problem children. The legitimate situations, by and large, we just don't have that kind of problem.

Senator GRASSLEY. Let me ask this since your statistics might indicate to people that this may not statistically be much of a problem. Then in the same vein as Mr. Pearlman suggested that we want to be careful that we don't encourage the movement toward tax shelters and tax avoidance, could we also say that the use of religious fronts when compared to the vast amount of people who are tax evaders and tax avoiders and tax shelters, isn't it relatively insignificant of that number? And isn't it also relatively insignificant in the growth of tax protesters? You know, those tax protesters that really get the publicity don't seem to be the ones that are associated with religious organizations. They tend to be the ones who think the income tax in and of itself is unconstitutional.

Commissioner EGGER. Well, of course, there the constitutional protesters. But the problem with the use of the church fronts is that although the institutions as such may be very few in the universe, the number of taxpayers involved can be considerable. I think we have something like 15,000 cases under examination right now of individuals where they have used churches as their tax avoidance or tax evasion scheme. We have them all over the country.

Senator GRASSLEY. But the 15,000 would apply to how big of a pool of tax protesters, tax avoidance and tax shelter types that you are suspicious of.

Commissioner EGGER. I can only tell you how many we have under examination. I wish I knew what the universe really is. But if we take that whole group—tax protesters and shelters and all the rest of it—we've probably got 350,000 cases under examination right now.

Senator GRASSLEY. My next question is whether your cases are handled in the exempt organization section of your agency or the tax shelter section.

Commissioner EGGER. Oh, no, no. The church examinations are handled by our exempt organizations group. We have what we call key districts and we have exempt organization specialists. And all of these examinations are handled by them.

Senator GRASSLEY. Well, how do you distinguish tax shelter cases from questions involving legitimate churches?

Commissioner EGGER. The only way we can do that is upon examination. When we find a situation that warrants investigation either by our criminal investigators or by the regular exam staff, we simply refer the cases to them. But, typically, this does not involve the church itself, the church organization itself. It almost always involves the individuals who are using the institution as a front for their tax evasion activities.

Senator **Grassley**. If these cases, tax shelters on one hand and make believe churches on the other, are handled by different divisions of the IRS why will this provision slow the processing of tax shelter cases?

Commissioner **Egger**. Well, it's a matter of coordination. Let me just describe how the typical tax protester type situation arises. Almost invariably, the first clue comes from selection of an individual tax return for examination because of the unusual deduction for contributions to a church or declaration of a vow of poverty or something else on the return that triggers that examination. That leads us, then, to the organization itself. And in order to trace the flow of funds and so on, it's necessary for us then to initiate an examination of the church in order to see what the transactions are between the individuals and the church and third parties and that sort of thing.

That calls for a coordinated examination. And so what happens is the examination division will ask for a coordinated examination with our exempt organization personnel. And then they work together from that point on.

We are not so concerned about such things as the pre-exam conference and things of that kind. We would do that in the typical case. And we do do it in cases where the taxpayers ask for it. My only concern is that by mandating it in the statute we would like to be sure that the drafting is such that it doesn't give merely another delaying tactic for the people who do use this as a tax evasion device.

Mr. **Pearlman**. Mr. Chairman, let me add one item. And it's really a comment on the 15,000 number. Fifteen thousand cases represents a lot of tax protester cases involving people claiming some benefit from charitable deductions or exempt church rules, even though in the absolute 15,000 may not seem like a lot in the context of general tax shelter cases—which really is not the subject of our comments this morning—but virtually no day goes by when you don't see something in the newspaper about a tax protester using the church to avoid some tax responsibility that most of the rest of us have. These protesters are very visible, and they are very vocal. And we are concerned about their harm to the system. So I would hope that the subcommittee would not walk away thinking, well, gee whiz, if there are 350,000 tax shelter cases and there are only 15,000 protester cases involving churches that that is not very important. We think it is very important in the context of the integrity to the tax system to try to stop people who are out there promoting blatant tax evasion through improper use of the church tax exemption.

Senator **Grassley**. Well, I was only trying to show, just in case somebody might read the statistics of 199 cases as maybe being insignificant—I wanted to put it in a perspective of your concern about the tax shelters.

I guess my view would be we ought to think in terms of the numbers, whether they are large or small, are significant in both cases because we are concerned about trampling upon people's rights. We might only have a few whose rights are trampled upon, but we ought to show the same concern about that as we do about the people who are avoiding taxes.

Commissioner **Egger**. Mr. Chairman, let me just add one more footnote here. I'm reminded by the staff that the 15,000 figure that I used is a group of protesters that are not necessarily related to the use of churches as fronts, but that the total number of illegal tax protesters amounts to some 40,000 to 60,000 that are under examination.

What we would like to do is to give you final statistics that can be inserted in the record on all of that.

Senator **Grassley**. Well, we will accept those, too. In fact, encourage you to give them to us.

[The information from Commissioner Egger follows:]

On further review of our examination closing records for the last three fiscal years we determined that we pre-examined 199 organizations that either were or claimed to be churches. Out of the 199, we examined 129. The information supplied in our pre-examination eliminated the need to examine the other 70 organizations. The principal issue in 17 of the examinations was liability for unrelated business income tax. The principal issue in the rest of the examinations was qualification of the organization for exempt status.

Fifty four of the 129 examinations were concluded favorable to the organization. Had those 54 furnished the information during pre-examination, there is a high probability that we would not have examined them.

Of the remaining 75 cases, which we closed with some kind of change, 17 were concerned with issues such as social security or employment tax. Seven of the examinations were of organizations that had discontinued operations and wound up their affairs and thus their exempt status terminated. Twenty one of the cases were agreed denials/revocations and one was an agreed unrelated business income tax change. The remaining 29 cases are still open in some stage of appeal.

As of August 19, 1983, the Service had an inventory of 37,063 illegal tax protestor returns, with 29,321 under examination and the rest awaiting examination. Of these, 15,478 returns involved alleged churches, with 12,867 in some stage of examination and the rest awaiting examination.

During fiscal year 1983, through August 19, 1983, we closed examinations on 14,522 returns involving illegal tax protestors. The recommended additional tax and penalties in those cases totaled almost 90 million dollars. Of those, 5,018 involved alleged churches, with recommended additional tax and penalties exceeding 18 million dollars.

Senator **Grassley**. I would like to help you and Mr. Pearlman with your concern about the evidentiary threshold. I guess we ought to consider whether elsewhere there are Federal evidentiary standards which would be of assistance to us in arriving at a proper threshold. For instance, rule 4-1 of the Federal Rules of Evidence defines relevant evidence as evidence having any tendency to make the existence of any fact that is of consequence to the determination of the action more probable or less probable than it would be without the evidence. Would that be of any help in defining the proper threshold?

Mr. **Pearlman**. Mr. Chairman, I think that is certainly something that we are willing to consider and discuss as we further discuss the provisions of the bill. But I would like to note to you that we are concerned by any standard that contains the word "evidence." And our concern is that in the body of the court decisions the word "evidence," which is obviously very critical in a lawsuit, has involved into a massive body of law involving what is or is not evidence and what is or is not relevant evidence.

We don't want to foster that kind of controversy in the examination process. We would hope—and our statement intentionally uses the words "facts" and "information"—we would hope that by focusing on those terms that we can demonstrate that it is appropriate that the Revenue Service has facts and information before it commences an examination of the church's books and records. People will recognize that that language means that the Revenue Service would not be going on a fishing expedition of those books and records.

We would hope that also in the process we can evolve a language that is satisfactory, mutually satisfactory, to everyone concerned. I would just want to throw that one cautionary note on using any standard that contains the word "evidence."

Senator **GRASSLEY**. Mr. Egger, as a practical matter I would like to know whether your exempt organization section has preexamination contacts with taxpayers, and then in regard to that, whether offering taxpayers a conference causes any significant delay in the current procedure.

Commissioner **EGGER**. Well, under the procedural rules which are spelled out in our Manual, of course, we have the correspondence with the taxpayer. And then all taxpayers, including churches, are offered a conference as a right. So the preexamination conference, which is set forth in the bill, would simply be a duplication of that conference which is offered automatically to all taxpayers.

Again, I don't have a problem with it so long as we can look carefully at the drafting to make certain that it doesn't offer an opportunity for unreasonable delay in those cases where the taxpayer is seeking to evade taxes.

Senator **GRASSLEY**. How long does it take the IRS to conclude the average church audit once it has begun? And then I am particularly concerned with the fact that you think the 365-day limit presents a real hardship to the IRS. I don't think Mr. Pearlman offered this, but if you think 365 days is too restrictive, what would be a reasonable time?

Commissioner **EGGER**. I'm not sure I can tell you right now what the average timespan is for these audits. But we certainly will supply it to you.

[The information from Commissioner Egger follows:]

We do not keep statistics on the length of time it takes to conduct an examination. Consequently, we do not know the average time span for church organizations and because various events can affect the conduct of an examination, a church examination can take from six to nine months to several years. A pre-examination may be concluded in a month or two if the organization answers the questions in the pre-examination letter or letters. An examination, even a relatively simple one, takes considerably longer because of the procedural steps that must be followed.

Steps that would consume time during a church examination include preparation and possible District Counsel review of at least two pre-examination letters; response time of at least 15 days for each pre-examination letter; analysis of the responses to the pre-examination letters; preparation of the recommendation for examination and notification of examination for the Regional Commissioner; clearance of the recommendation and notification through the Regional Commissioner; mailing of the notification letter at least 30 days before the on-site examination is begun;

conduct of the on-site examination; preparation of the examiner's report and recommendation; review of the examiner's recommendation; and mailing of the letter.

Circumstances may affect the length of time it takes to conduct any stage of the examination. Additional pre-examination letters may be sent in an attempt to resolve questions without conducting an examination. The time afforded for response to preexamination letters may be longer than 15 days as 15 days is the minimum response time. Approval of the recommendation for examination may take several months as reviewing officials give them careful consideration. The time it takes to conduct the on-site examination depends on the complexity of the organization and the completeness of its records. The examination may raise issues requiring National Office Technical Advice and a legal opinion of the Office of Chief Counsel. The complexity of the issues will also affect the time it takes the examiners and reviewers to analyze them and reach a conclusion. Finally, an organization's exercise of its appeal rights following an adverse decision will extend the time it takes for the case to be resolved.

The examination time will be longer if the organization is uncooperative. Vague or unresponsive answers to questions are often used to delay proceedings as they require the Service to seek information through other means, such as additional letters or a summons.

Commissioner **Egger**. My concern here with the 365 days is that by the time the institution goes through all of the appellate steps there are, typically, several months of delay. I say delay, but it just takes that time to go through it. And I'm troubled by the fact that we might get up to the deadline there and we would be forced to make an assessment in order to protect the revenues and make an assessment that might be based on incomplete information, and that sort of thing.

And I don't think any of us want that. What we would like to do is to work again with the staff here to see what we can do about the statute of limitations that will not be unreasonable either way. At the moment, I'm not prepared to say whether it's 2 years, 3 years or whatever. But I would like to join Mr. Pearlman in simply recommending that we sit down in a staff arrangement and try to work that out.

Senator **Grassley**. Assuming that this bill before us is enacted, why would it be important to force a church to administrative appeal, such a decision through the IRS, if both the Regional Commissioner and the Regional Counsel of the IRS need to approve the examination of a church? And, of course, I know you spoke against whether—Mr. Pearlman did—the need for having the regional counsel involved.

Commissioner **Egger**. Well, let me just address that briefly, and then respond to your question. The Chief Counsel of the Internal Revenue Service is, in effect, the legal advisor to the Commissioner and to the other line officers in the Internal Revenue Service. In that sense, it's like any other attorney-client relationship. And the regional counsel provides essentially that same service to the Regional Commissioner.

Now if you have the attorney having to approve as well as the client having to approve, it changes the role of the line officers. In other words, it now becomes the responsibility of the legal advisor to make line decisions. And it's that that we don't want to upset.

The Regional Commissioners invariably rely on the legal advice of their counsel in all cases where it is indicated. So what we don't want to do is upset that line responsibility.

Now as to the process, the mere fact that the Regional Commissioner approves an examination doesn't mean that he knows in advance what is going to be discovered, or what is going to be uncovered, or what is going to come out of the exam process. And so there is no way of foretelling what the issues will be once the examination gets underway. The mere fact that he has to be involved on the front end doesn't mean that the normal administrative process shouldn't take place before it's time to resort to the courts.

Senator **Grassley**. The three or four questions I anticipated for you, Mr. Pearlman, have been discussed already so I think we can dismiss you as a panel. And thank you very much for your time. And I know that in your testimony there is ample willingness to work with us and a flexibility, it seems like. So I feel encouraged by your testimony. And particularly encouraged by the administration's views toward this legislation.

Thank you both very much.

Commissioner **Egger**. Thank you.

Mr. **Pearlman**. Thank you, Mr. Chairman.

Senator **Grassley**. Pardon me. Would you please sit down? There is an issue here that you brought up that I anticipated asking you about that was in a different form.

Mr. Pearlman, the existing law provides for special procedures before examining church, what are called, books of account. How do you now define "books of account?"

Mr. **Pearlman**. Under current law—and, Commissioner, if I am incorrect, say so—under current law, books of account are those financial and accounting records possessed by the church. A church's own corporate records, such as minutes and so forth, and other things that are within the direct possession of the church, would traditionally be viewed as the personal records, but not the "books of account" of the organization.

The concern we have in a change in that standard is an expansion of a limitation on the Service's ability to go beyond those financial records that are possessed by the church or by the taxpayer under examination. So what we are suggesting is we think it is quite appropriate that a notice be given to that taxpayer and the appropriate procedures initiated if the Internal Revenue Service wants to contact that church and begin an examination of that church's records.

We are concerned that we try to keep the Service and the church apart as much as possible. And we don't want to create unnecessary contact between the Service and the church unless it is determined that it is appropriate. However, if the term in the bill "books and records of the church" were to be construed to mean third-party records, records in the possession of third parties, then it would mean the Service would have no ability to communicate with anyone to do any inquiring about items that come up in connection with other examinations or irregularities that appear on tax returns of other taxpayers such as individuals without first going through the rather complicated notice of procedure in the bill applicable to books of account.

And that's the distinction that we would suggest is appropriate. And I would hope that that distinction would assure the kind of protection that you are seeking to assure the churches in the examination processes.

Senator **Grassley**. For those church records that are not classified as books of account, does the IRS have the right to examine these records without procedural standards?

Mr. **Pearlman**. Well, if we talk about third-party records, the answer is "no." There are procedures currently in the statute not limited to churches that are applicable to all taxpayers which assure taxpayers that before the Internal Revenue Service examines any third-party records, the taxpayer is given an opportunity—indeed, it's a judicial opportunity—to interfere with that examination if the taxpayer believes it is appropriate.

So the church would not be left with no protection. Indeed, it has protection today, as does every other taxpayer, to make sure that contacts by the Internal Revenue Service with third parties is not inappropriate or is not relevant to an appropriate tax examination.

Commissioner **Egger**. Mr. Chairman, our manual has some rather explicit and fairly lengthy listings of things that we believe are books of account, and things which we believe are not books of account. This is not intended to be an exclusive list, but for the guidance of our examining officers and so on. We would be happy to submit that for the record so you will have it.

Senator **Grassley**. Please do. And that's the last question. Thank you.

Commissioner **Egger**. Thank you.

[The information from Commissioner Egger follows:]

Attached are IRM 7(10)71.22 church books of account, and exhibit 7(10)70-5, examples of records that are and are not books of accounts.

would not apply to an examination of the organization. Any reasonable doubt about the possible presence of more than a clearly insignificant factual basis for claiming church status should be resolved in favor of any organization formally asserting such status.

(8) Under the First Amendment, the Service is precluded from considering the content or sources of a doctrine which is alleged to constitute a particular religion, and can make no attempt to evaluate the content of whatever doctrine a particular organization claims is religious. Examiners conducting pre-examination inquiries and examinations of organizations claiming church status must make no attempt to evaluate the content of any particular religious doctrine.

7(10)71.22 *(1-29-81)*
Church books of Account

(1) Church books of account are the accounting and bookkeeping records of the church kept in the regular course of business to provide a detailed financial history of business transactions of the church. They include all books of original entry.

(a) See Exhibit 7(10)70-5 for examples of records that are and are not books of accounts.

(b) If there is a question as to whether or not particular records constitute church books of account, District Counsel should be consulted.

(2) The pre-examination procedures need not be followed when examination is being made only of records that are not church books of account, such as records maintained by a bank.

7(10)71.3 *(8-31-81)*
Pre-examination Procedures

(1) The pre-examination procedures do not constitute an examination within the purview of the "only one inspection" provision of IRC 7605(b). Therefore, the use of these procedures does not bar the conduct of any comprehensive examination that might thereafter be initiated in accordance with 30-day notice procedures provided for in IRM 7(10)71.41:(6), below, and Treas. Reg. 301.7605-1(c)(2).

(2) There is no hard and fast rule as to what specific information may be obtained under the pre-examination procedures. Generally, the Service may request any information relevant to the proper areas of Service inquiry. The information requested should be limited to that which the organization can reasonably compile and assemble, and which is necessary to resolve the area or areas of inquiry. The pre-examination procedures should not be conducted so as to take on the essential character of a comprehensive examination of the organization's books of account. If the issue or issues cannot be resolved through these pre-examination procedures, the examiner should consider the need for requesting the Regional Commissioner's approval of an examination under the procedures of IRM 7(10)71.41, below.

(3) The EP/EO key district office will commence the pre-examination inquiry by sending a written request to the organization consisting of a pre-examination cover letter, and specific questions, as appropriate, using Exhibit 7(10)70-2 as a guide.

(a) In preparing this pre-examination letter, the period of time permitted for response should represent a reasonable amount of time for the organization to gather and furnish the information requested. This period will generally not be less than 15 days, subject to variance on a case-by-case basis. In determining what a reasonable response time will be, examiners should give consideration to the size of the organization, the type of records requested, and the amount of information the organization is being asked to provide.

(b) The pre-examination letter will be issued by certified mail with return receipt requested. When the district office prepares the pre-examination cover letter, the words "CERTIFIED MAIL" should be entered in capital letters above the salutation. The signed return receipt should be made a part of the file, as should a return receipt evidencing refusal to accept the letter.

(c) See Exhibit 7(10)70-1 for Pattern Letter P-645(9-80) Pre-Examination Cover Letter.

(d) See Exhibit 7(10)70-2 for a checksheet of suggested pre-examination letter questions. These questions should aid in developing cases to the fullest extent at the earliest stage, thus minimizing the need for additional correspondence with the organization. Pre-examination letters containing questions that deviate substantially from those set forth in Exhibit 7(10)70-2 should be approved by District Counsel.

(4) If the organization responds and satisfactorily furnishes the information requested, an appropriate acknowledgment will be made. If the information indicates that the organization meets or continues to meet the requirements for exemption from Federal income tax, the pre-examination inquiry will be closed in accordance with the procedures outlined in IRM 7(10)71.3:(8), below.

Exhibit 7(10)70-5

Examples of Records That Are And Are Not Books Of Account

This list, which is not intended to be exclusive, distinguishes between documents that are books of account and those that are not books of account. Note that books of account include all books of original entry.

Books of Account

- General ledger
- General journal
- Accounts receivable ledgers
- Accounts payable ledgers
- Cash disbursements book
- Cash receipts book
- All subsidiary ledgers
- Voucher register
- Check register
- Purchases journal
- Sales journal
- Check books
- Savings account books
- All specialized journals

Not Books of Account

- Certificate of Incorporation
- By laws
- Charter
- Checking account information held by financial institution
- Minutes of meetings
- Articles of Incorporation
- Publications
- Correspondence
- Tax returns
- Exemption letters
- Records filed with municipal and state offices

Senator GRASSLEY. Our next panel will come forward. Mr. Coleman, Mr. Liken, Mr. Williams, and Mr. Dugan.

I have just been informed by staff that we may have rollcall votes commencing in a few minutes. And if so, that means I am going to have to go. It looks like there will be one major vote, and then a half hour break for me to come back. And there might be a whole series of votes. If there is a whole series of votes, I don't know what I'm going to do about completing the hearing. I will have to wait until that time.

I would like to take time now to introduce each one of you. Michael Coleman is testifying today as the chief financial officer of Gulf Coast Covenant Church, a 1,200 member church located in Mobile, Ala. He became personally familiar with the Internal Revenue Service's church audit procedures when his church was audited over an 18-month period at the cost to it of over $100,000 to defend its innocence. No tax was assessed, and the exempt status of the church was upheld.

Mr. Liken is a practicing tax attorney in Philadelphia, primarily representing various religious organizations. Before entering private practice, he served for 28 years in the Office of the Chief Counsel of the Internal Revenue Service. He was an Assistant Regional Counsel in charge of Houston and the Regional Counsel for the Mid-Atlantic Region before his retirement from IRS.

Mr. Williams is the newly appointed director of the Rutherford Institute. He is the principal spokesman of the Virginia based Christian Legal and Educational Institute dedicated to the protection of religious liberties and first amendment freedoms. The Rutherford Institute is active in a variety of research, consultation, and litigation activities.

Robert Dugan is the director of the Office of Public Affairs of the National Association of Evangelicals, a position in which he has served for the past 5 years. He holds a masters degree in divinity from Fuller Theological Seminary and is now serving his 26th year as an ordained pastor.

I would ask you to go in the order that I introduced you.

So, Mr. Coleman, Mr. Liken, Mr. Williams, and Mr. Dugan. And I would say to you that we are going to have the light come on in 5 minutes, so we have asked you to summarize. And your entire statement will be put in the record. And I will ask each of you to testify and then we will have questions for you.

STATEMENT OF MICHAEL COLEMAN, PRESIDENT, NATIONAL INTEGRITY FORUM, WASHINGTON, D.C.

Mr. COLEMAN. Mr. Chairman, I am pleased to have the opportunity to testify today in support of S. 1262 because it will afford churches greater due process from the Federal Government.

As you have already stated, I am the financial administrator of Gulf Coast Covenant Church, and my presence here is the result of nearly 3 years of interaction with IRS. This interaction encompassed an onsite audit of my church which covered 5 years of activity—1975 through 1979. The actual onsite examination lasted 5 weeks and had as many as three IRS agents present at times. In addition, further investigation consumed hundreds of man-hours, and our total costs were over $100,000.

Our interaction with the IRS ended in our church's exoneration. No taxes were assessed, and our exempt status was upheld as a church. All that this painful and expensive investigation by the IRS proved was that we were a legitimate Christian church, something we knew all along.

The present day statute, 7605(c), which S. 1262 will amend, was passed in 1969 as part of the Tax Reform Act. The statute is ambiguous as is illustrated by the Ninth Circuit Court of Appeals decision in *U.S.* v. *Coates*. And I quote:

> If a tax statute is ambiguous, as is true of section 7605(c), this court will adopt interpretation that results in the statute's construction in harmony with the general scheme of the Internal Revenue Code.

There is great judicial confusion and variance in the court interpretations on this tax law due to the ambiguity of the present statute. Clear congressional action is necessary regardless of the number of cases of abuse because the present statute is fatally flawed.

If S. 1262 is not passed, there will continue to be great tension and confusion as to the respective roles of the IRS and the church in America and how they should relate to one another.

It is absolutely imperative that the problems that exist today in this arena not be left to unelected officials in the Federal agency. Congress should be resolute and clear in enunciating boundaries for these activities as they relate to churches. The IRS has proved over and over again that they cannot regulate themselves, and many of the IRS agents that have approached churches in these proceedings in recent years have shown an anti-church attitude by coming in with prejudiced opinions against the church and taking an attitude that the church is guilty until proven innocent.

Our Government should not be in the role of persecuting the church where it is acting in legitimate and law abiding activities. The present procedures have so much latitude in them that abuses have occurred.

It is significant to note that bill S. 1262 is the result of a very widely based effort among many churches and religious groups to help the IRS solve these problems.

Present day preexamination procedures and other items that are listed in S. 1262 need to be clarified at a legislative level. I would like to point out that in our audit we did contact numerous Federal officials to try to discuss these problems. It is my intent in testifying to assist, by being a part of a legitimate Christian church, the IRS in defining these procedures.

We were in contact with numerous officials in the White House, Treasury Department, including the Assistant Commissioner for Exempt Organizations, S. Allen Windborne, the Vice President's office, and numerous congressional officials. The result of our contact in attempting to intercede for a solution to our difficulties basically was that we got the bureaucratic runaround. Most of the responses were boilerplate and not sufficient to inform us of the specific issues enjoined in our audit.

I support S. 1262 and look forward to assisting in any way possible to see that we have viable legislation to assure that legitimate churches are not abused and illegitimate tax protest groups do not go on in abuse of the tax laws.

Thank you.

Senator **Grassley**. Actually, you have until the red light comes on.

[The prepared statement of Mr. Coleman follows:]

Testimony of Mike Coleman
Before the Subcommittee
on Oversight of the Internal Revenue Service
of the Committee of Finance of the United States Senate

September 30, 1983

Mr. Chairman, members of the committee, I am honored to have the opportunity to appear before you today. I support S.1262 and recommend that it become law to afford churches greater due process from the federal government.

I am the financial administrator of Gulf Coast Covenant Church, a local Christian church in Mobile, Alabama, consisting of approximately 1200 members. My purpose in appearing before this committee today is to assist the federal government (the Internal Revenue Service in particular) and the Church at large in more clearly defining our respective roles in American society. It will be necessary to pass this legislation for this to be accomplished.

My presence here is the result of nearly three years of interaction with the IRS. This interaction encompassed an on-site audit of my church which covered five years of activity (1975-1979) and took a full five weeks to complete, with as many as three IRS agents present at times. In addition, further interaction consumed hundereds of man-hours and over $100,000 in costs to the church. Our interaction with the IRS ended in our church's exoneration. No taxes were assessed, and our exempt status as a church was upheld.

I am not here to attempt to recover our financial losses. Rather, I am here to give positive input to the Congress so that other churches can avoid in the future the kind of unwarranted pain and expense that we experienced. All that this painful and expensive investigation by the IRS proved was that we are a legitimate Christian church - something we knew all along.

The purpose of the Church Audit Procedures Act is to provide a legislative solution to a delicate and sensitive problem: clearly defining the role the IRS should have in auditing churches. Its purpose is to set in law certain procedures that will keep the IRS from going on "fishing expeditions." The bill would also provide a safety net wherein legitimate churches could be protected. At the same time, this bill will not hinder the IRS's ability to deal with illegitimate or tax-protestor groups operating under the guise of a church. This bill will amend the present IRC 7605(c) section.

The present day statute 7605(c) of the Internal Revenue Code was passed as part of the Tax Reform Act in 1969. This act, for the first time, provided for unrelated business income tax to be applied to churches. Congress, reacting out of concern that the IRS might abuse its authority in examining this newly applied tax, passed 7605(c) of the IRC. This section of the IRC has already been litigated in several federal courts, including four circuit court decisions. Those decisions are U.S. v. Holmes, No. 79-3023, U.S. Court of Appeals, Fifth Circuit, March 31, 1980; U.S. v. The Freedom Church, No. 79-1281, U.S. Court of Appeals, First Circuit, December 28, 1979; U.S. v. Dykema, No. 80-2750, U.S. Court of Appeals, Seventh Circuit, December 9, 1981; U.S. v. Coates, Nos. 82-4013, 82-4025, U.S. Court of Appeals, Ninth Circuit, November 18, 1982.

Study of these circuit court decisions and the lower federal court decisions reveals that a great deal of ambiguity and confusion exists in the federal court system in trying to interpret the present day statute. The legislative history on the present day statute is very sketchy and poor. To illustrate, the Ninth Circuit Court said in U.S. v. Coates, and I quote, "If a tax statute is ambiguous, as is true of section 7605(c), this court will adopt interpretation that results in the statue's construction in harmony with the general scheme of the Internal Revenue Code." It is very clear that the present day statute is ambiguous and difficult for the federal court system to interpret when conflicts have arisen between the IRS and churches. As one studies this problem, it becomes irrefutably evident that the present 7605(c) law must be changed, regardless of the number of cases of IRS abuse of churches. One case of abuse of a legitimate church in America is too many, especially given the First Amendment restrictions found in the U.S. Constitution. This proposed legislation before us today in the bill S.1262 will go a long way toward resolving such judicial confusion.

The IRS does indeed have a difficult job in overseeing the whole realm of tax exempt organizations. Their job is especially difficult when it comes to the area of overseeing churches, because a church is a religious organization protected by the First Amendment of the Constitution. The problem in overseeing religious organizations is further complicated by recent Supreme Court decisions that expand the meaning of religion to include such non-theistic faiths as secular humanism. Another complicating factor is that a number of the current IRS agents that have dealt with churches do not understand the nature of the church, and they have approached the situation with certain prejudiced opinions believing the church to be guilty until proven innocent. The IRS needs help from legitimate Christian churches in defining their role of assuring the integrity of the tax system of the United States as it relates to churches. The present bill before the committee is the result of a widely based effort among numerous churches and religious groups to develop the changes in the tax law that must be made to assure that churches are treated fairly by the IRS. At the same time, this bill would not prevent the IRS from dealing with illegitimate groups who abuse the tax laws.

It is important that the problems with the present day statute be solved by Congress. The interpretation of the problems in this arena and their solutions must not be left to unelected officials and a federal agency. Congress is responsible as the elected body and should be clear and resolute in its intent, so that the IRS will have clear boundaries for its activities.

At this point, I would like to outline a brief procedural overview of how the IRS audits a church under the present day statute of 7605(c). Whether by informant information, a referral from a field examination of an individual by a revenue agent, or by some other means, the IRS will initiate proceedings against a church. It begins with pre-examination, which consists of written communications between the IRS and the church. The regulations under 7605(c) of the IRC and section 7(10)70 of the Internal Revenue Manual are the two sources of procedure and authority used by the IRS in this process. This pre-examination process can take up to six months and sometimes longer. At the conclusion of the pre-examination stage, the pre-examination agent may request that the Regional Commissioner grant authority for a field examination to be conducted on the church. The Regional Commissioner then approves or disapproves the request.

If he grants authority to do an audit, he will issue a letter notifying the church that it will be examined by an exempt organizations specialist and that it has thirty days before the agent will be in contact with it to schedule the dates for the audit. At this point, the IRS tells the church not only to have the books of account available, but also minutes, correspondence, contributors lists, etc. In other words, every operational document of the church must be available. At the conclusion of the investigation, the IRS will rule as to whether tax should be assessed and whether or not the exempt status of the church should be upheld or denied.

There are several important porvisions of S.1262 that will change the current 7605(c) statute. First, this bill establishes a stronger evidence requirement on the Regional Commissioner before starting an examination, and it expands the scope of the examination procedures beyond unrelated business income tax to include the tax exemption of the church. Under the present statute 7605(c) no statutory procedure exists for the IRS regarding any examination of a church's exemption under 501(c)3 of the IRC. The judicial debate over whether or not the present day 7605(c) law covers examination for tax exemption reflected in numerous federal court decisions is evidence of the need to include the examination of exempt status under S.1262. The new and clearer evidence requirement in S.1262 is an absolute necessity to assure that unwarranted "fishing expeditions" by the IRS do not occur in the future. The bill does not change the present day statute as it relates to having the Regional Commissioner authorize any examination of a church.

Second, S.1262 creates clear statutory procedures for the pre-examination stage of an investigation. These procedures are contained in particular under sections 7605(c)2, 7605(3) and 7605(c)4. Section 7605(c)2 starts the pre-examination process by informing the church of the IRS concerns about the church. It also gives the church clear notice of these concerns and the laws governing the IRS-church relationships, so that the church can respond properly, including securing an attorney, etc. Section 7605(c)3 establishes the requirement for the Regional Counsel to review any proposed recommendation for a formal examination by the Regional Commissioner. This is to assure the quality control of the exam and to help eliminate the possibility that an investigation would be expanded to an on-site examination when a legitimate church is involved. Section 7605(c)4 closes the pre-examination process with a conference between the church and IRS officials, at which time the legal and/or factual issues could be discussed - hopefully eliminating the need for a formal examination when a legitimate, law-abiding church is involved.

Because of these three sections of S.1262 (outlined above) the church will be better informed as to the future it faces in relating to the IRS under these laws. Please remember that most churches and church pastors are not legal experts. The present day pre-examination questonnaires, sent by the IRS, are basically boiler-plate. These questionnaires from the IRS are not designed to solicit definite, specific information. They are procedural in nature and are not designed to fully inform the church of what the legal and/or factual issues are concerning the church and how the IRS intends to proceed. The offering of a conference under S.1262 to the church before a formal examination occurs is one of the most important provisions of this bill. It affords the opportunity for the church to "sit across the table" from IRS agents and discuss the facts of the case. Many of the churches who have undergone IRS examinations in the last several years have never been given information to let them know what the IRS concerns were so that they could properly respond and resolve any disputes. It has been a very antagonistic relationship, where the IRS has assumed that the church is guilty until proven innocent. Please refer to exhibit A attached to my testimony. It explains in depth what happened to Gulf Coast Covenant Church. The story of our audit can be compared to the provisions of S.1262 to demonstrate how such abuses could be eliminated if this bill were passed into law.

Third, the present day statute, 7605(c), applies restrictions on examination of the books of account of a church to determine the tax to be assessed. It also imposes a restriction on religious activities, so that they are not to be examined "except to the extent necessary" to determine if the organization is a church. S.1262 makes a significant change by expanding the term from books of account to include all church records. This will insure that all of the records of the church are protected and not just the accounting records. All of the federal court cases between the IRS and churches in the last several years have been over summons enforcements where the IRS demanded all of a church's records. The IRS has approached churches even in the pre-exam stage requesting all documents of a church. Many of the church materials the IRS requested were not necessary to examine to determine if, in fact, the organization in question was a church, or to determine the amount of tax to be imposed. This provision of S.1262 will assure protection of First Amendment rights for sensitive religious materials of churches, such as confidential correspondence between a pastor and a parishoner, or the minutes of a church's elder's meetings where confidential information about church members are discussed and prayed about, or other similar matters. It would also provide the same protection to church records kept by third-parties or financial institutions.

Fourth, S.1262 imposes a one-year time limit or 365 days upon the IRS to complete an examination of a church. This one-year time limit exists in S.1262 to assure expeditious treatment of church examinations. In the case of our audit, it lasted two and one-half years and had a deleterious effect upon our church because of the financial strain and the associated mental pressure. Please refer to exhibit A for further description of what happened to Gulf Coast Covenant Church. This 365-day period can be suspended if the IRS has to bring a legal action against the church to obtain information, or it can be suspended if the church brings legal action against the IRS. This provision will afford a statutory basis for churches to urge the IRS into expeditious treatment of their case.

Fifth, S.1262 provides for an injunctive relief provision and the recovery of legal costs by the church. If a church can prove before a federal judge that irreparable harm has occured, due to the IRS violating the provisions of S.1262, the court will stop the IRS from continuing such violations by issuing an injunction on that particular activity. There should not be abuse in this area because it is very difficult to get an injunction upheld in a Federal Court and it would afford churches a means of recourse not presently available under the law.

This provision of S.1262 also allows for recovery of court and legal costs. This is an especially important provision wherein a church can recover costs incurred due to unreasonable or illegal IRS actions. These provisions are afforded to other taxpayers and should be afforded to churches as well. The costs to defend our church's innocence in an audit, which lasted two and one-half years, was over $100,000. This includes staff time, attorney fees and CPA fees.

Sixth, this bill establishes a statute of limitations for churches. Presently a statute of limitations does not exist for churches because a church is not required to file any tax returns. Retroactive revocation of a church's exempt status and the associated tax assessments could go back many years because there is no statute of limitations. This provision is designed to prevent punitive action by the IRS through such retroactive revocation beyond three years. Every other taxpayer enjoys a three-year provision for the statute of limitations because they file a return. The provision of not filing a return by a church should not confer upon the IRS the extraordinary ability to go back past three years. It should not be an impediment to administration of the tax laws of this country to afford churches a three-year statute of limitations.

Seventh, the bill (S.1262) provides that under section 7605(c) a church does not have to exhaust its administrative remedies before it could go into court to seek a declaratory judgement on its exempt status. The point at which this would occur would be when the IRS sends the notice that they are revoking the exempt status of the church or that they are assessing unrelated business tax. This provision will assure that a church will have a speedy avenue to pursue settling any dispute in court before an objective third-party.

I trust that my testimony has served the purpose of more clearly defining the respective roles of the government and the church. I hope that greater effort will be given by the Congress to remedy the problems outlined in my testimony by passing S.1262.

Mr. Chairman, I appreciate your courtesy in allowing me to testify. Thank you.

Testimony of Mike Coleman
Before the Subcommittee
on Oversight of the Internal Revenue Service
of the Committee of Finance of the United States Senate

September 30, 1983

Exhibit "A"

The Story of Gulf Coast Covenant Church

Our church, Gulf Coast Covenant Church (formerly known as Gulf Coast Fellowship) was formed in 1972 with 80 members as a Bible-believing Christian Church. We were granted exempt status as a church in a determination letter from the I.R.S. on March 29, 1973. By the end of 1975 the church membership had increased to approximately 600 members in the local area with other churches in other parts of the country associating with us. Therefore, we applied for an exemption letter to cover our subordinate churches. This exemption was granted on March 31, 1976.

We have been a church that has attempted to pioneer New Testament concepts and what we see a Christian church should be. Our theology is in the mainstream of historical Christianity and is evangelical in posture.

Over the years, we have had several attorneys counsel us on various matters. One attorney who has advised us has been Mr. John Heard of the law firm of Vinson and Elkins of Houston, Texas. Had it not been that he provided his services gratis, we would not have been able to afford such excellent legal advice. Also, it had been our standing policy to write the Internal Revenue Service directly when we had questions on tax procedures. Previously, we had asked for and received technical advice from the National I.R.S. office on several matters. In summary, ours was a posture of openness and honesty with the I.R.S.

In keeping with this posture, in January 1979, we wrote to the I.R.S. updating them on our current status and asking several questions. None of those questions were specifically answered.

Then, quite unexpectedly, in March 1979, we received twenty questions from the I.R.S. in Jacksonville, Florida, with notification that we had thirty days to answer them. These questions took us totally by surprise; we had no idea of their purpose or their implications, nor was there any information provided by the I.R.S. as to the reason for the inquiry. We answered their questions to the best of our ability, formulating ten pages of answers, various exhibits and newspaper articles about our church. We even enclosed a copy of our 1978 financial statement. We stated in the cover letter to these questions that our desire was to comply with the laws applicable to our church. However, our legal counsel and the church had serious concerns about some of the questions asked of us. Some of their questions applied to private foundations and not churches, and others raised serious questions about the constitutionality of the I.R.S. questionnaire, since it dealt with theological issues.

Then, in June 1979, we received another fifteen questions. It seemed evident that, for reasons unknown to us, the I.R.S. did not believe our answers to the first set of questions. They asked about ordination requirements, and we gave them our requirements based upon biblical principles which we have established for our ministers. Then, as if disregarding the validity of these requirements, they asked for the educational requirements for ordination. They asked for a list of substantial contributors, a list of the five highest paid employees and the amounts they are paid, and other questions that indicated to us their mistrust of the integrity of our church operations. Our continuing frustration was that they would never specifically address the legal and/or factual points in question. Neither would they allow us conference rights in Jacksonville, Florida, in order to determine what they wanted. They were approaching us as if we were guilty before we ever even had a hearing or had an opportunity to present any pertinent facts to them.

Finally, in November 1979 (eight months later) we received a letter from the Regional Commissioner, Mr. Harold McGuffin in Atlanta, informing us that the I.R.S. intended to do an on-site audit of our church. In the letter of notification for the audit he asked for the minutes, contributors list, correspondence files, books of account, bank records and other similar information. After this letter, we saw the seriousness of the situation and that it would be a long-term encounter with the Internal Revenue Service. We responded to the Regional Commissioner by letter stating that we would only allow the audit under protest and that we would not disclose the minutes or contributors list.

For six months after the date of this Regional Commissioner's letter we wrote the I.R.S. requesting that the church be notified of the specific reasons for the audit, what issues were being questioned and what years of church business they intended to audit. We were never notified of the specific reasons for the audit nor how the audit would be conducted. It was only after six months and three letters and numerous phone calls that we found out they intended the audit for the years 1975 through 1979. This notification came only six weeks before the actual audit was to occur.

The auditing agent scheduled three different dates as dates that the audit would begin. However, all of these dates were subsequently changed. As a result of this, the schedules of both the church and its pastors were severely disrupted. Finally, on June 2, 1980, six months after we were notified that we would be audited, the audit started and lasted five weeks, with as many as three I.R.S. agents present at one time.

During the five-week audit of the church, we gave the I.R.S. over 1100 copies of documents. We signed numerous sworn affidavits and did everything else we knew to do to answer their questions. They went through just about every transaction that our church had had in the five year period they were investigating. Needless to say, it was a very, very thorough audit on the part of the I.R.S.

Right in the middle of the audit the agent suspended the audit to go on his vacation, saying he did not know when he would be back to finish it. This greatly frustrated us because we had been trying in every possible way to have this audit concluded so we could give ourselves to more positive church activities. This whole Internal Revenue Service entanglement with our church prevented us from moving forward with many church activities. We could not implement a retirement plan for our ministers, purchase property for our church needs, or emphasize growth in our outreach publication ministries because we did not have the financial resources to defend ourselves and also expand our ministry in these ways. In fact, we could not have defended ourselves as we did had we not had numerous other churches which contributed to help defray our defense expenses.

The deleterious effects of the encroachment by the I.R.S. upon our church cannot be adequately conveyed in this paper because it is larger than the sum total of the parts that I describe. They were haughty and high-handed. They failed to answer our calls or respond to our correspondence. They misrepresented the facts to us on numerous occasions and were evasive. They were unresponsive to several Congressmen, Senators and Administration officials who attempted to determine the real purpose of their procedures against our church. We continually found ourselves with no real recourse to solve the problems and had to continue to fight this ordeal through the slow and unresponsive bureaucratic system of the I.R.S.

Back in December 1979, after nine months of unsuccessfully trying to determine charges or allegations against us, our attorneys filed a Freedom of Information Act request with the I.R.S. We felt that there must be something or someone prejudicing the I.R.S. against us.

After our Freedom of Information Act request was handled very irresponsibly, we appealed in April 1980 to the national office for an administrative review of our request. Then, five days before the actual audit occurred, we found out that the I.R.S. had concealed stolen internal documents of our church. It was not until late May 1980, that the I.R.S. returned internal documents of our church to us that they had held in their possession for nearly three years. These documents allegedly were turned in to the Internal Revenue Service by an anonymous informant. Needless to say, our attorneys and our church were completely shocked. The fact that the I.R.S. initiated this audit against us and never told us that they held in their possession stolen internal documents of our church heightened our sense of the injustice of their actions.

What makes it even worse is that we had made a Freedom of Information Act request and an administrative appeal to the national office of the I.R.S. and they had still not informed us of these documents. As our attorneys and I reviewed the documents, it became very apparent why the I.R.S. would want to look into our church. The documents that were stolen and turned in to the I.R.S. were presented in such a slanted way as to arouse suspicion concerning the activities of our church. These stolen documents consisted of offering envelopes and cancelled checks. We do not object to the fact that the I.R.S. inquired or that they had a right to inquire. In fact, if they had been honest with us, we would have only had to go through about 35% of the process that we went through and we could have settled all issues to the satisfaction of the Service and the church. In fact, once we had an opportunity to answer the questions in the audit that were generated by these documents, the issues were resolved to the satisfaction of the I.R.S., since the documents were then considered in the total context of our church activities.

We readily acknowledged that the I.R.S. has a legitimate function that they need to perform in overseeing tax-exempt organizations. However, the way in which they handled these documents and other aspects of this audit greatly concerns us.

After the audit was over, we filed suit in October of 1980 in Federal Court against the I.R.S. under the Freedom of Information Act, because it was very apparent that they had not dealt honestly or legally with us in this matter. The Justice Department sent one of their attorneys to Mobile to discuss the case with us. When we challenged them on the legal issues involved they dropped opposition to one of our motions for a Vaughn Index of the rest of the documents remaining in the file and ultimately we settled out of court. We then found that they had not returned all the original documents to us. In fact, they gave us another copy of our 1975 financial statement which we had already given to the agents six months before in the audit. They also returned copies of several 1040 tax returns of our church members (our senior pastor, treasurer and accountant). Our

C.P.A. was later audited for the first time in over twenty years of practice.

It is evident from the Freedom of Information Act documents that the I.R.S. used the stolen information and other information to compile a list of individuals and organizations associated with our church with a view to initiate audits on them.

We cannot prove this with 100% certainty but the preponderance of evidence indicates that at least three audits on individuals which were conducted were directly a result of the audit on the church. I was audited in 1979 after I had listed myself as the man to contact on the pre-examination questions. Our main attorney, Michael Ford, was audited shortly after he filed a power of attorney to represent the church before the I.R.S., and then in the Spring of 1981 another administrative staff member was audited. The result of all of these individual audits was that either there were refunds issued to the audited individual or a small amount of tax was paid (under $100.00). So, it is obvious that none of the staff had been engaged in any illegal activity rendering these personal audits, in my opinion, strictly a form of harassment.

It took the I.R.S. one year to make a decision on the result of our church audit. Even though we came out of this whole process with our exempt status intact, these proceedings have had an extremely deleterious effect upon all of us who have been involved with them. We believe that the cumulative effect of all that happened to us is an infringement on our Constitutional rights as a church. The sheer length of the inquiry alone has punished and deterred our church from its constitutionally recognized pursuit of religious freedom.

This entire incident doesn't really have any winners. We, as a church, lost a great deal and so did the I.R.S. Our church lost a great deal of confidence in our government because of this audit. We had approached our government with openness and honesty but we didn't find the reciprocate with the same attitude.

It cost us over $100,000 to defend our innocence. Having this cloud of investigation hanging over our church for two and a half years damaged our reputation and dignity. The mental tenseness and anguish we experienced through this ordeal was something I would never wish on someone else. It affected the forward motion and direction of our church, delaying implementation of some plans for several years. It also cost us hundreds of man-hours, finally necessitating that my job responsibilities be adjusted so that I could handle this on a full-time basis.

It also cost the I.R.S. a great deal. It cost them and the Justice Department a great deal of money and man-hours to pursue this over almost three years only to find us innocent. They lost the confidence of a constituency who sought to deal with the government as an agent they believed to be ordained by God. They have lost the confidence of the larger Christian community as the result of other positions they have taken on similar issues. They may well have also lost some self-esteem, because they could not possibly feel proud of the treatment afforded our church.

It is regretful that this audit occured because it could have been avoided. My concern is for the small church or the taxpayer with little resources to defend themselves. I wonder if there is true "poor man's justice" any more because for a private citizen or small organization to defend their rights against the power and complexity of the federal government, they must have enormous resources to retain attorneys, other legal assistance and the ability to fund hours of work and research.

My hope is that such abuse will not occur again. Passage of S.1262 will go a long way toward assuring that churches will be treated fairly by the I.R.S.

STATEMENT OF ROBERT L. LIKEN, PHILADELPHIA, PA.

Senator GRASSLEY. Mr. Liken.

Mr. LIKEN. I want to thank you very much for the opportunity to appear here today. In addition to my other qualifications, although I do not represent the church, I am a member of the board of directors of the Presbyterian Church in America, and a member of the Permanent Committee on Administration. And I hold other offices in the church as well.

This bill has two basic purposes, as I see it. One is to make sure that the church is not subjected to unnecessary examination by requiring a more effective communication between the Internal Revenue Service and the taxpayer; and second, by providing a more effective view before a determination is made to examine a church.

There is no point in summarizing the proposed bill because it has been summarized several times today. Let me go to specific provisions: Protection of church records versus books of account. The present statute prohibits examination of books of account unless the secretary notifies the organization and so on. The term "books of account" pertains only to accounting records. It does not cover all records of the church. And I recommend that all records of the church be covered.

The most confidential and important records of the church are not covered under the existing section of the code. Such items as minutes of the sessions do not come under the term "church records." I have a copy here of the Internal Revenue publication which makes that clear. It's exhibit 7(10)70-5 of Examination Procedures 7(10)00 (8-20-79).

Now the second item I would take up is examination of a church's exempt status. At the present time, section 7605 has certain restrictions upon examinations to determine whether there is unrelated business income and the tax on that unrelated business income. But it does not provide restrictions on examinations to determine whether the church is an exempt organization, whether it qualifies as a church.

Now it's a curious fact that the statute gives special protection to routine accounting records but not to the most sensitive records of the church. And that there is restriction upon determining whether there is a tax, but not upon determining whether it is a church and qualifies under section 501(a) as an exempt organization.

I think this should be changed. Now there seems to be some confusion as to what the regulations of the Internal Revenue Service provide in this regard. Section 301.7605-1(3) specifically says that the present provisions of section 7605(c) do not extend to the examination of a church to determine whether it is a church. So I recommend the restrictions of section 7605(c) be extended to cover all records of the church and to cover an examination to determine whether a church is an exempt organization under section 501(a) of the Internal Revenue Code.

Review by regional counsel. The legislation proposes that the Regional Commissioner would transmit to the Regional Counsel a recommendation to examine a church. And the first question, of course, is why is this needed? Well, the answer is that it will provide an independent legal and factual review by competent attorneys. The attorneys of the Chief Counsel's Office—the Regional Counsel is a part—are highly respected throughout the profession. And they would give a sound review I'm sure. I call upon my experience in private practice and also in the Government in recommending this provision.

The proposed bill requires Regional Counsel concurrence in the proposed action. I do not think it's necessary that there be concurrence by Regional Counsel. I think that if the bill said "referred to Regional Counsel for a review and recommendation," that that would be satisfactory. I can't see a Regional Commissioner taking action over the recommendation of a Regional Counsel unless such action was very, very thoroughly considered. And that is actually what we are after here today: thorough consideration of the determination to audit a church to avoid unnecessary examination.

There is a lot of talk about Service lines of authority. It's not unusual in the operation of the agency to require that matters go to Regional Counsel for review before action is taken.

I see that my time has expired.

Senator **Grassley**. All right.

[The prepared statement of Mr. Liken follows:]

ROBERT L. LIKEN
905 WOODBROOK LANE
PHILADELPHIA, PENNA. 19119

PENNSYLVANIA BAR
DISTRICT OF COLUMBIA BAR
UNITED STATES TAX COURT

215-242-6890

Testimony of Robert L. Liken Before the Subcommittee on Oversight of the Internal Revenue Service of the Finance Committee of the United States Senate September 29, 1983

Mr. Chairman:

I testify today in support of the proposed legislation known as The Church Audit Procedures Act of 1983, S. 1262, H. R. 2977.

It is the purpose of this legislation to make sure a church is not subjected to the expense and travail of an unnecessary examination by Internal Revenue. The bill proposes to do this by requiring Internal Revenue to more effectively communicate with the church and requiring a more effective review of the determination to examine a church.

The bill in my opinion, has several highly desirable provisions:

1. The Bill protects all church records, and not just a church's books of account.

2. The Bill extends pre-examination procedures to cover an examination to determine whether a church qualifies as an exempt organization under Section 501(a) of the Code. Present restrictions extend only to examinations to determine whether a church has unrelated business income and the tax on it.

3. The Bill provides a legal and factual review by Regional Counsel of a proposal to examine a church.

4. The Bill gives the church an opportunity to sit across the table from representatives of Internal Revenue to find out what is bothering the IRS and to give the IRS a better opportunity to obtain the facts needed to make a sound determination. This is closely related to Sec. 7605(c)(2), which directs Internal Revenue, at the pre-examination stage, to reveal the facts known to it and the issues presented. The purpose is to give the church a clearer understanding of the situation.

5. The proposed legislation also contains several other provisions -- a 365 day period of limitations for examination and administrative determination, a provision for injunctive

relief if IRS "violates provisions," allowance of costs and attorney's fees, a three year period of limitations on assessment of tax, and exhaustion of administrative remedies. I shall discuss these provisions.

I. PROTECTION OF CHURCH RECORDS VS. BOOKS OF ACCOUNT:

Section 7605(c), IRC[1/] prohibits examination of a church's books of account unless the Secretary notifies the organization in advance. The term "books of account" is defined in Internal Revenue Manual, Exhibit 7(10)90-5, page 7(10)00-52 to include only accounting records, such as ledgers and journals.

The amendment to Section 7605(c) prohibits examination of church records unless the Secretary follows certain procedural steps. See proposed Sec. 7605(c)(3) and 7605(c)(6), The term church records covers all records of the church, including confidential correspondence, Minutes of the Session, or other highly sensitive and confidential communications and records which arise frequently in the ordinary course of church government.

Recommendation: I recommend the restrictions of Section 7605(c) be extended to all church records, as proposed in S. 1262, sections 7605(c)(3) and 7605(c)(6).

II. EXAMINATION OF A CHURCH'S EXEMPT STATUS:

One of the most significant changes proposed under S. 1262 relates to extension of the restrictions of Sec. 7605(c) to an examination to determine whether a church qualifies as an exempt organization under Sec. 501(a).

Present Sec. 7605(c) contains restrictions on examination of a church to determine whether it may be carrying on unrelated trade or business activities, but does not cover an examination to determine whether the organization qualifies as a church under Sec. 501(a).

Certain it is an examination to determine whether an organization qualifies as a church involves a much more sensitive relationship between church and state than mere determination of the tax the church may owe.

It is a curious fact that present Sec. 7605(c) gives special protection to a church's routine accounting records but not to the most sensitive records a church has; and places restrictions on examination of a church to determine whether it owes tax on unrelated business income but not to the more sensitive question whether the organization is a church.

Objections: There seems to be some confusion whether Treasury Regulations extend the restrictions of Sec. 7605(c) to examinations to determine whether the organization qualifies as a church. The answer is the Regulation not only does not do so but Regulations § 301.7605-1(3) specifically denies the applicability of Sec. 7605(c) to examination of a church's exempt status. It reads:

> "The requirements of subparagraph (2) of this paragraph that the Regional Commissioner give notice prior to examination of the books of account of an organization do not apply to an examination of the religious activities of the organization for any purpose described in this subparagraph."

This view is also found in the Internal Revenue Manual. 7(10)71,21(4).

Recommendation: I am of the opinion the restrictions of Sec. 7605(c) should be extended to cover an examination to determine whether an organization is a church.

III. REVIEW BY REGIONAL COUNSEL

Proposed Sec. 7605(c)(3) would require the Regional Commissioner to submit a recommendation for examination of a church to the Regional Counsel for review and concurrence in the proposed action. This proposal raises several questions.

1. Why Is It Needed?

The first question is whether Regional Counsel review is needed? The answer is it will provide an independent legal and factual review by competent attorneys of the highly sensitive decision to examine a church. The purpose is to be as sure as the government can be that there is a sound basis for examination of a church.

In reaching the conclusion the proposed measure is sound I draw upon my experience in the government and in private practice. The attorneys in the Office of the Chief Counsel of Internal Revenue, which includes the Regional Counsel of the seven regions, are highly respected throughout the tax profession for their ability, professionalism, and objectivity. I think review of that caliber is needed.

In private practice I represented a large bible-believing church during an examination of its exempt status. The examination was authorized by a Regional Commissioner after two sets of questions had been addressed to the church. In each instance the church responded fully and accurately, but it was not enough. This was the result of the fact the Regional Commissioner's people did not ask about the transactions IRS was interested in. As a result, the District Director's factual justification for the proposed examination consisted of facts the IRS did not ask about. I think we need someone to review these cases who will give the case a thorough review.

It is my opinion the Regional Commissioner probably would not have authorized the action if he had submitted the case to the Regional Counsel for review. This conclusion is based in part on the fact that when the case reached Regional Counsel it was rejected.

2. REGIONAL COUNSEL'S CONCURRENCE?

The proposed legislation requires the Regional Commissioner to submit the case to Regional Counsel for review and concurrence. A question has been raised as to whether it is proper to require Regional Counsel concurrence in the proposed action. It is said this gives Regional Counsel a veto over the Regional Commissioner.

It is my opinion the legitimate purpose of the proposal would be as well served if the statute merely required the Regional Commissioner to submit the case to Regional Counsel for review and recommendation instead of concurrence. It is not likely a Regional Commissioner would fail to take notice of the views of Regional Counsel.

3. Service Lines of Authority.

A question has also been raised as to whether the submission of the case to Regional Counsel for review would be inconsistent with Service lines of authority. If the word "concurrence" were changed to "recommendation", as suggested, this should remove any possible objection. That is, the Internal Revenue Manual is replete with instances where action by the Regional Commissioner's side of the agency must be submitted to the Regional Counsel for review prior to final action. For example, a proposed statutory notice of deficiency in a fraud case must be submitted to counsel prior to issuance. See IRM, Audit 4469, page 4400-48.4. Another example, perhaps closer to the instant proposal, the Regional Commissioner must submit his recommendation to refer a case to a grand jury for investigation to the Regional Counsel for decision and the Regional Counsel takes final action.

IV. OFFER A CONFERENCE:

Section (c)(4) of the proposed legislation directs the Regional Commissioner, prior to submission of the case to Regional Counsel for review, to notify the organization he is considering whether to examine the church. Further, the Regional Commissioner is required to list the concerns which give rise to the question, the relevant legal and factual issues, and a description of all evidence discivered to date. In addition he must offer the church the opportunity to meet with IRS to discuss the facts, evidence and issues relevant to the proposed investigation.

In short, Sec. (c)(4) requires the Regional Commissioner's people to lay their cards on the table face-up and tell the church what is bothering the IRS.

The purpose of proposed Sec. (c)(4) is to provide the most effective means of communication possible to be sure the church is fully aware of the problems and the facts needed.

In the past, the Service has sought to develop the facts by use of an elaborate pre-examination procedure. IRM7(10)71.3. This system has two weaknesses:

(1) The church officers who receive the requests for information frequently do not know what IRS is talking about. On the other hand, IRS personnel may be less than candid and open. It is believed that if representatives of the church sit across the table from IRS personnel it may have a good effect on both sides.

(2) The second basic weakness in the present system is the fact the IRS questions tend to be boiler-plate, designed to play the procedural game required by present Sec. 7605(c) but not to reveal what is generating IRS's interest.

I heretofore referred to the fact I was counsel for a church which was examined. After the examination was complete we finally found out, through an extensive and expensive Freedom of Information action, what caused IRS to examine the church. We learned the IRS had some reason for asking the church to explain certain matters but the pre-examination questions did not touch the sensitive spots. I believe that if the IRS had been more open and candid the matter could have been resolved in a hurry.

Objections: It has been said a description of the evidence could be harmful to the Service's ability to perform a fraud investigation. I do not believe in lying behind a log and shooting at the other side. It is an inefficient way to administer the tax laws. Nonetheless, the objection does have some merit in certain cases, such as fraud.

Recommendation: I strongly support the conference provision but I suggest an exception for issues where the government would have the burden of proof.

V. THE 365 DAY LIMITATION ON EXAMINATIONS:

Sec. 7605(c)(7) requires the Service to make a determination not later than 365 days after the organization is first notified of commencement of the examination.

I understand Treasury feels the Service could not complete a complicated church examination within 365 days without an adverse effect on the quality of the examination and technical review. I believe Treasury's objection is sound. For example, it is not possible to complete many criminal investigations within 365 days.

I am also concerned that this provision might work to the detriment of the church and sound tax administration. That is, if the Internal Revenue Service is faced with a rapidly expiring deadline, which makes further factual study not feasible, the Service will resolve all doubt against the church, and perhaps it should.

Recommendation: 1. It seems to me the 365 day limitation provision would have more merit if it contained a waiver clause, thus giving the church an option whether it desires to force Internal Revenue to a speedy but perhaps premature and improvident decision.

2. I also recommend an exception for cases wherein the government must sustain the burden of proof.

3. In any event, the proposed amendment should be revised to make clear the day when the 365 day period begins to run. It seems to me it should begin on the day the Service sends final notice of examination under Sec. 7605(c)(5).

VI. PARAGRAPH (c) AT PAGE 7 OF H. R. 2977 -- NO REQUIREMENT TO EXHAUST ADMINISTRATIVE REMEDIES:

The proposed amendment provides that if the Secretary notifies an organization he intends to revoke its status or to assess unrelated business income tax against it, the church shall be deemed to have exhausted administrative remedies. This provision is sound.

The only administrative remedy available at that point is a protest to the Appeals Division. After a case has been reviewed and approved by Regional Counsel and the case has been personally endorsed by the Regional Commissioner, there is little point in talking with the Appeals Division.

VII. INJUNCTIVE RELIEF:

Proposed Section 7605(c)(8) grants jurisdiction to a United States District Court to enjoin any activity which "violates the provisions of this subsection." I am troubled by this provision. It is unprecedented in tax law and procedure. I do not know the ramifications of it nor the purpose behind the provision.

It seems to me the provision might introduce into taxation the excessive formalism we see in criminal pleadings and procedure. I am opposed to that.

This Bill should not provide avenues for a nonqualified organization to obtain or retain exempt status. The provisions are merely designed to insure full communication and opportunity to present the relevant facts. The church cannot ask for more.

Recommendation:

Delete this provision.

1/ SEC. 7605. TIME AND PLACE OF EXAMINATION.

(c) Restriction on Examination of Churches.--No examination of the books of account of a church or convention or association of churches shall be made to determine whether such organization may be engaged in the carrying on of an unrelated trade or business or may be otherwise engaged in activities which may be subject to tax under part III or subchapter F of chapter 1 of this title (sec. 511 and following, relating to taxation of business income of exempt organizations)unless the Secretary (such officer being no lower than a principal internal revenue officer for an internal revenue region) believes that such organization may be so engaged and so notifies the organization in advance of the examination. No examination of the religious activities of such an organization shall be made except to the extent necessary to determine whether such organization is a church or a convention or association of churches, and no examination of the books of account of such an organization shall be made other than to the extent necessary to determine the amount of tax imposed by this title.

STATEMENT OF TEDD N. WILLIAMS, EXECUTIVE DIRECTOR, THE RUTHERFORD INSTITUTE, MANASSAS, VA.

Senator GRASSLEY. Mr. Williams.

Mr. WILLIAMS. Thank you, Mr. Chairman.

The Rutherford Institute supports Senate bill 1262. I will limit my comments briefly to three areas that have been discussed—the question concerning the 365-day limitation, the threshold evidence question and the injunction aspect of the act.

First as to the time limitations, the Church Audit Procedures Act will not hamstring the IRS in conducting legitimate and necessary investigations, but rather will require the IRS to act efficiently and only with probable cause when investigating a church.

It should be noted that the 365-day limitation period is suspended if the organization institutes litigation to challenge the IRS or the organization unreasonably refuses to cooperate with any reasonable request for necessary information or materials.

So in other words, the Service is given 365 days in which to conduct an unhindered investigation with a cooperative agency or cooperative taxpayer. And we would submit that this allows adequate time to conduct an investigation and come to a conclusion. If, because of litigation being instituted, or because of an unreasonable refusal to cooperate, the IRS is unable to complete its investigation, then the limitation is tolled.

Second, as to the threshold evidence question. It simply should not limit necessary investigations. Where a church status is being used for a tax evasion, the IRS will inevitably have sufficient evidence of wrong-doing to conduct an investigation. And the only requirement that would be imposed by the act is that the Service would have evidence which reasonably—which leads to a reasonably held belief that the investigated organization is guilty of some specified wrong-doing.

I would submit that this is analogous to a probable cause requirement, which law enforcement agencies in every State and every Federal law enforcement agency utilize every day. And it's quite a workable basis for supporting the act.

However, where there is nothing more than an unsubstantiated third party allegation, such as from a disgruntled member of a church, then the IRS would not have the power to conduct what I would term an intrusive investigation. That is, plowing into church records and church minutes and church financial documents.

Finally, as to the injunction aspect. If the foregoing parts of the act are reasonable, the injunction provision is too. The injunction provision merely requires that the Internal Revenue Service adhere to the provisions of the act.

I point out that it does not enjoin an investigation. It does not provide for enjoining an investigation or a proceeding. Rather it provides for enjoining an investigation or proceeding that is violative of the act. It's needed in order to terminate matters quickly and briefly. It will save money for the taxpayers. It will save money for the churches. It will save money and headaches for the Internal Revenue Service.

I believe that the Federal Rule of Evidence, rule 401, is an excellent case in point of the type of standard that can be used. It would make the injunction provision, the evidence provision, and the statute of limitations provisions all work together so that where there was some real evidence of wrong-doing, the investigation can take as long as need be. But where there is no actual, reasonable evidence, the investigation would be hastily and briefly concluded without undue expense.

One last point that I would suggest as a possible addition to the act would be, with respect to the statute of limitations, provide that the taxpayer can waive the statute of limitations. This would avoid the problem of coming down to an 11th-hour deadline where the IRS is leaning toward exoneration, and is really forced to make a decision one way or the other.

Now if we have an uncooperative taxpayer that refuses to cooperate, the time limit is tolled or suspended anyway. And if we have a cooperative taxpayer and it's heading toward exoneration, the deadline can be waived.

Thank you.

Senator GRASSLEY. Thank you.

[The prepared statement of Tedd Williams follows:]

STATEMENT
OF
TEDD N. WILLIAMS
ON BEHALF OF
THE RUTHERFORD INSTITUTE
IN SUPPORT OF THE CHURCH AUDIT PROCEDURES (CAP) ACT
BEFORE THE SUBCOMMITTEE
ON THE INTERNAL REVENUE SERVICE OVERSIGHT
OF THE
UNITED STATES SENATE FINANCE COMMITTEE
SEPTEMBER 30, 1983

I submit this statement on behalf of the Rutherford Institute. I am Executive Director of the Institute. The Institute initiates and participates in lawsuits concerning free speech, free exercise of religion, and other constitutional issues. It represents a broad range of clients from Protestants to Roman Catholics to Orthodox Jews. The Institute also conducts research and publishes papers on constitutional topics as well as conducts conferences and seminars on various subjects for professional and lay audiences.

It should not surprise anyone that the Internal Revenue Service is opposed to the Church Audit Procedures Act. Currently, Section 7605(c) of the Internal Revenue Code has been interpreted to give the IRS broad discretion in examining the records, financial and otherwise, of American churches. Undoubtedly IRS has grown accustomed to this lack of restraint. However, to allow this virtually unfettered discretion to continue will present opportunities of abuse by overzealous IRS officials. The result will be serious infringement of First Amendment rights, as well as disastrous financial consequences for legitimate churches that are required to become involved in extensive administrative or legal proceedings to protect their rights. This is not "doomsday prophecying". Instances of abuse under the present Section 7605(c) can be cited. Thus, the problem is real.

Nevertheless, the IRS will likely persist in its opposition to the Act. The IRS may argue, among other things, that the CAP Act will "hamstring" its efforts to enforce tax laws, either due to time limitations or evidence requirements imposed by the Act. It may also argue that the current Section 7605(c) is adequate to protect churches from unnecessary examinations. Finally, the IRS may argue that the CAP Act's evidentiary requirement would violate the Supreme Court's decision in United States v. Powell, which held that Section 7605(b) did not hold the IRS to a probable cause standard. In this testimony I would like to refute these arguments.

First, as to the time limitations, the Church Audit Procedures Act will not hamstring the IRS in conducting legitimate, necessary investigations. Rather, the CAP Act will require the IRS to act efficiently and only with probable cause when investigating a church. The 365 day limitations period is suspended if the investigated organization institutes litigation to challenge the IRS investigation or if the investigated organization refuses to comply with "any reasonable requests...for information or materials necessary for the conduct of the investigation." In other words, the IRS has 365 days in which to conduct an unhindered investigation with a cooperative organization. This allows adequate time for the IRS to conduct an investigation and come to a conclusion. If, due to litigation or unreasonable refusal to cooperate, the IRS is unable to conduct its investigation, the 365 day limitation does not run. Under these circumstances, IRS objections to this period of limitations can only highlight the Service's inefficiency. The Service would prefer to have the power to draw out the investigatory process and, in so doing unreasonably pressure those under investigation to cooperate long after matters should have been resolved.

Secondly, the IRS may also object to the evidence requirement as hindering necessary investigations. This is simply not the case. Where church status is being used for tax evasion, the IRS will inevitably have sufficient evidence of wrongdoing to conduct an investigation. The only requirement imposed by the Act is that the IRS possess evidence which leads to a reasonably held belief that the investigated organization is guilty of specified wrongdoing. This is analogous to a probable cause standard, which is the minimal level of protection in a free society. However, where no more than an unsubstantiated third-party allegation has been made against a legitimate church, the IRS will not have the power to conduct an investigation without more. The evidence requirement will not hamper IRS correction of real abuses.

Thirdly, the Supreme Court's decision in United States v. Powell does not preclude the evidentiary requirement proposed by the CAP Act. The Court held in Powell that Section 7605(b) did not require the IRS to establish probable cause before examining a private citizen's records. The Court noted that the probable cause standard might hamper the IRS's ability to carry out investigations. The Court specifically stated that it was unwilling to impose this burden on the IRS absent Congressional intent to impose the probable cause standard. In other words, the probable cause standard is not unconstitutional and is entirely justifiable, as long as the legislative history makes it clear that the standard was intended by Congress.

Finally, the present Section 7605(c) does not adequately protect churches from unnecessary investigations. It is true that Section 7605(c) was intended to protect churches, but it has been so broadly interpreted that it now affords no protection at all. Federal Circuit Courts of Appeal have blindly applied the holding of the Supreme Court in U.S. v. Powell without examining the Supreme Court's reasoning. As a result, the legislative history of the present Section 7605(c) has largely been ignored.

That legislative history clearly shows Congress's intent to protect churches by holding the IRS to a higher standard in dealing with churches. Section 7605(c) was added to the Internal Revenue Code in 1969, making churches for the first time subject to the unrelated business income tax. The last sentence of Section 7605(c) limits IRS investigations to "the extent necessary." This last sentence is referred to as the Bennett Amendment.

In introducing his amendment, Senator Bennett stated:

> [T]he bill...for the first time, allows the Internal Revenue Service to audit churches.
>
> This has not been possible under the previous law. And the language of the bill, I think, is too loose....
>
> There is fear that the language would open it up so that the IRS could go through all the church books that pertain to religious activities.
>
> They did not intend to do this; therefore, the IRS agrees with me that the limiting language will have uses.

CONG. REC. 37,483 (daily ed. Dec. 6, 1969).

If interpreted and applied properly, Section 7605(c) might have been adequate to protect churches from IRS abuses. But it has been interpreted by lower courts to be no more restrictive of the IRS than is Section 7605(b). This has led to situations where the IRS demands access to church correspondence files, board meeting minutes, and other confidential records, with no evidence of any wrongdoing on the part of the church. Unfortunately, many federal courts have upheld these demands. This broad inquisitional power must be restricted, at least in cases where there is no evidence of any wrongdoing.

In summary, the proposed Church Audit Procedures Act is needed to protect legitimate churches from unnecessary IRS investigations. Requiring the IRS to have evidence of wrongdoing before launching an investigation and demanding confidential information will provide that protection. However, the requirement will not hamper IRS investigations of illegitimate organizations. Rather, the CAP Act will reverse the IRS's apparent attitude that churches are guilty until proven innocent. Thank you.

STATEMENT OF ROBERT P. DUGAN, JR., DIRECTOR, OFFICE OF PUBLIC AFFAIRS, NATIONAL ASSOCIATION OF EVANGELICALS, WASHINGTON, D.C.

Senator GRASSLEY. Mr. Dugan.

Mr. DUGAN. Mr. Chairman, thank you for your kind introduction, for the opportunity to testify and most of all for your leadership on this issue. I'm Robert Dugan, director of the Office of Public Affairs of the National Association of Evangelicals, an association of 38,000 churches included within 43 member denominations and an additional 35 nonember denominations.

Incidentally, we are not insensitive to the concerns of the IRS and the Treasury Department. Our counsel, the key person helping to prepare this testimony, Forest Montgomery, spent 25 years in those two divisions of the Federal Government, the last half dozen or so as counselor to the general counsel of the Treasury Department.

Seldom has our newsletter generated so much response as when we offered an overview of the Church Audit Procedures Act. This response evidences great interest and concern about the potential of an IRS audit of a church.

I'm not here to discuss IRS audits of churches in connection with the tax on unrelated business income. Only a small fraction of churches have occasion to be concerned about their liability for that tax.

We are concerned about IRS audits of the religious activities of churches. Nor are we here to contend for legislation that would hamstring the IRS in its proper efforts to control abuses of the law affording churches tax exempt status. Our concern is that the IRS in its understandable zeal to curb mail-order ministries, tax protestors and abuses of the tax laws seems determined to resist any attempt whatsoever to curtail its audit powers. That rigidity is nowhere more evident than in the IRS analysis of the proposed legislation that we had in hand as we prepared this testimony.

One searches that analysis in vain for an iota of sensitivity for those churches which have experienced the heavy hand of the tax auditor. The compelling testimony of Mike Coleman of the Gulf Coast Covenant Church before this committee in October 1981 is a matter of public record. And by the way, Mike Coleman came to us earlier in his forays to the Nation's Capitol in his concern about this developing problem.

Yet the IRS analysis never mentions that experience or even suggests that there is a problem with the manner in which it has audited churches. Indeed, the conclusion of the IRS analysis contains this unwarranted supposition. "We think that the intent of the bill is to insulate churches from reasonable Service review of their compliance of the tax laws." The problem, of course, is that Service review has not been reasonable as the testimony of Mike Coleman amply attests.

There is no need for me to sketch the details of his church's experience. I am simply here to say that we are here today to urge this committee to be receptive to the plight of small churches which have little resources to defend themselves from unwarranted IRS tax audits. Nor should larger churches with greater financial resources be forced to squander sums of money given for ministry to demonstrate their innocence.

Moreover, pastors are not often tax sophisticates. They need the protection this proposed legislation would afford. If the IRS had initially sat down with representatives of the Gulf Coast Covenant Church and indicated what the problem was, the church officials could have easily explained the situation and the audit would have been unnecessary.

Section 7605(c), as interpreted by the IRS, affords no protection whatsoever from unwarranted audits of a church's religious activities despite the good intentions of former Senator Wallace Bennett, who was responsible for the second sentence of that section. While Gulf Coast Covenant Church eventually was able to prove its innocence of any tax wrong-doing, it took 2½ years to do it and $100,000. A hollow victory, indeed, for that $100,000 should have been spent winning people to Christ; not battling Caesar.

Let me close by noting an important additional dimension to the issues I have discussed. The church is not just another 501(c)(3) exempt organization, though the IRS seems to treat churches that way. Under section 508(c) churches do not even have to file to obtain an exemption under section 501(c)(3). They enjoy or should enjoy a preferred status for they operate under the protection of the free exercise guarantee of the first amendment. While churches cannot be totally immune from scrutiny, we assert that the IRS, mindful of that constitutional guarantee, should be particularly sensitive to the unique status of the churches. We think it is possible to accommodate the principle of church-State separation without opening the floodgates to a deluge of blatant tax abuses in the name of religion. Surely any technical imperfections in this proposed legislation can be ironed out should they truly threaten to handicap the IRS in its legitimate efforts to prevent exploitation of 501(c)(3) exempt status.

We appeal to the IRS to acknowledge that a problem exists and assure this committee, as it knows, that it does. Something must be done to insure that the ordeal of the Gulf Coast Covenant Churc' does not befall others.

We are grateful that this proposed legislation has growing bipartisan support. It should.

Senator **Grassley**. Thank you, Mr. Dugan.

[The prepared statement of Robert R. Dugan, Jr., follows:]

NATIONAL ASSOCIATION OF
EVANGELICALS
OFFICE OF PUBLIC AFFAIRS/1430 K STREET NW/WASHINGTON DC 20005/(202) 628-7911

September 30, 1983, Statement of

ROBERT P. DUGAN, JR.

Director, Office of Public Affairs
National Association of Evangelicals

SUBCOMMITTEE ON OVERSIGHT OF THE INTERNAL REVENUE SERVICE
of the
SENATE FINANCE COMMITTEE
re:
S. 1262, the Church Audit Procedures Act of 1983

Mr. Chairman, members of the committee, I am Robert P. Dugan, Jr., Director of the Office of Public Affairs, National Association of Evangelicals. The NAE is an association of some 38,000 churches included within 43 member denominations and an additional 35 nonmember denominations. I appreciate this opportunity to testify on S. 1262 which, I can assure you, is of the utmost interest to our constituency. Seldom has our newsletter generated so much response as when we offered an overview of the Church Audit Procedures Act. This response evidences great interest, and concern, about the potential of an IRS audit of a church.

I am not here to discuss IRS audits of churches in connection with the tax on unrelated business income. Only a small fraction of churches have occasion to be concerned about their liability for that tax. What concerns the churches, and prompts my appearance today, is IRS audits of the religious activities of churches.

■NAE COMMISSIONS ☐Commission on Chaplains ☐Evangelical Churchmen Commission ☐Evangelical Social Action Commission ☐Evangelism and Home Missions Association ☐Higher Education Commission ☐Stewardship Commission ☐Women's Fellowship ☐World Relief Commission ■AFFILIATES ☐American Association of Evangelical Students ☐Evangelical Foreign Missions Association ☐National Association of Christian Schools ☐National Religious Broadcasters ☐National Sunday School Association ■SERVICE AGENCIES ☐Evangelical Family Service, Syracuse ☐Evangelical Child and Family Agency, Chicago ☐Family Ministries, Semitas, Calif. ☐Evangelical Purchasing Service
■National Office 3505 Main Place / Box 28 / Wheaton, Illinois 60187 / (312) 665-0500

At the outset, let me say that NAE is not here today to contend for legislation that would hamstring the IRS in its proper efforts to control abuses of the law affording churches tax-exempt status. Our concern is that the IRS in its understandable zeal to curb mail-order ministries, tax protesters, and abuses of the tax laws, seems determined to resist any attempt whatsoever to curtail its audit powers. That rigidity is nowhere more evident than in the IRS analysis of the proposed legislation.

One can search that IRS analysis in vain for an iota of sensitivity for those churches which have experienced the heavy hand of the tax auditor. The compelling testimony of Mike Coleman of the Gulf Coast Covenant Church before this committee on October 19, 1981, is a matter of public record. Yet the IRS analysis never mentions it, or even suggests that there is a problem with the manner in which the IRS has audited churches. Indeed, the conclusion of the IRS analysis contains this unwarranted supposition: "We think that the intent of the bill is to insulate churches from *reasonable* service review of their compliance with the tax law." (Emphasis added.) The problem, of course, is that Service review has *not* been reasonable, as the testimony of Mike Coleman two years ago before this committee amply attests. (With your approval, Mr. Chairman, I would like that testimony included in the record as an addendum to my testimony. Mike Coleman is a personal friend and we are familiar with the trials of his church at the hands of the IRS.)

Without going into Mr. Coleman's testimony in any great detail, let me just highlight some of the facts which underpin his persuasive appeal for legislative redress. The Gulf Coast Covenant Church is an evangelical church located in Mobile, Alabama. In March 1979 the church received twenty questions from the Jacksonville, Florida, IRS office with 30 days to answer them. No reason for the inquiry was given; the church had no idea what prompted the questions. The church made every effort to answer those questions. Three months later, in June 1979, they got 15 more questions. These questions seemed to reveal basic Service misgivings about the integrity of the church's operations, but the Service never specifically indicated what the problem was. Moreover the Service refused to meet with church officials in Jacksonville in order to determine what it was the Service wanted. In November 1979, the Regional Commissioner in Atlanta informed the church that IRS planned to do an on-site audit. The letter of notification asked for church minutes, contributors list, correspondence files, books of account, bank records — the whole gamut of such church records. Despite repeated requests, the IRS never notified the church of the specific reasons for the audit nor how it would be conducted. They finally received a notice six weeks before the audit that the IRS intended to audit the years 1975-1979.

It ultimately turned out that some disgruntled member of the church had stolen church documents and attempted to paint a picture of church wrongdoing — that church funds were being used for private gain. Once it knew what the problem was, the church was able to address the questions IRS had and all issues were resolved to the satisfaction of the government, because the stolen documents could be considered in the total context of church activities. The church received a "clean bill of health."

It cost the church $100,000 to defend its innocence. But aside from the financial burden, the cloud of an investigation hanging over the church for two and a half years damaged its reputation and dignity. As Coleman testified: "The mental tenseness and anguish we experienced through this ordeal were something I would never wish on someone else."

We are here today to urge this committee to be receptive to the plight of small churches which have little resources to defend themselves from unwarranted IRS tax audits. Nor should larger churches, with greater financial resources, be forced to squander sums of money given for ministry to demonstrate their innocence. Moreover, pastors are not often tax sophisticates. They need the protection this proposed legislation would afford. If the IRS had initially sat down with representatives of the Gulf Coast Covenant Church and indicated what the problem was, the church officials could easily have explained the situation and the audit would have been unnecessary. S. 1262 would require that simple step, as well as others designed to deal fairly both with the church and with the IRS.

Section 7605(c) as interpreted by the IRS, affords no protection whatsoever from unwarranted audits of a church's religious activities, despite the good intentions of former Sen. Wallace Bennett who is responsible for the second sentence of that section. While Gulf Coast Covenant Church eventually was able to prove its innocence of any tax wrongdoing, it took two and a half years to do it — and $100,000. Theirs is a hollow victory, for that $100,000 should have been spent winning people to Christ, not battling Caesar.

Let me close by noting an important additional dimension to the issues I have discussed. A church is not just another 501(c)(3) exempt organization, though the IRS seems to treat churches that way. Under section 508(c), churches do not even have to file to obtain exemption under section 501(c)(3). They enjoy, or should enjoy, a preferred status, for they operate under the protection of the free exercise guarantee of the First Amendment. While churches cannot be totally immune from scrutiny, we assert that the IRS, mindful of that constitutional guarantee, should be particularly sensitive to the unique status of churches. We think it is possible to accommodate the principle of church-state separation without opening the floodgates to a deluge of blatant tax abuses in the name of religion. Surely any technical imperfections in this proposed legislation can be ironed out, should they truly threaten to handicap the IRS in its legitimate efforts to prevent exploitation of 501(c)(3) exempt status.

We appeal to the IRS to acknowledge that a problem exists. We assure this committee that it does. Something must be done to insure that the ordeal of the Gulf Coast Covenant Church does not befall others. Action by Congress at this time is imperative, for the recent changes in the Social Security tax laws further expose churches to IRS audits.

We are gratified that this proposed legislation has growing bipartisan support. It should.

End

Senator GRASSLEY. Each of you did keep within your limits, and I want to thank each of you for that.

Mr. Coleman, you have been very helpful to this subcommittee in the past in testifying on attorney's fees. And you have had an experience, or your church has, with the subject matter of this legislation. So as you look at this bill, which portion of it would have prevented the unfortunate examination that your church underwent? And why would those portions of the bill work to your benefit?

Mr. COLEMAN. There are 10 portions to the bill. I think the preexamination procedures under section 2 would have been extremely helpful because we would have had an opportunity to have questions asked us which were specific; they would have been designed to solicit the kind of information that would have settled any dispute or concern the IRS had.

The provision on including all church records would have been very helpful. The agent came to our church with a signed summons in his briefcase for our minutes, contributors' list, and pastoral correspondence. We told the agent that as long as he treated us as a legitimate Christian church we would cooperate, but they would not receive those documents because of the religious nature of them. Our minutes, for example, have discussions of confidential nature between pastor and parishioner and there were other Biblical and religious subjects that are taken up. And I could not see the IRS' right to, for example, examine correspondence between a pastor and a depressed parishioner.

So the preexamination procedures would have helped. The expansion from books of account to church records would have helped.

Another provision that would have helped is the offer of a conference. We asked on numerous occasions for a conference. And I would like to go on the record as stating that the IRS preexamination procedures, contrary to previous testimony, do not presently afford a conference to churches in the preexamination stage. So that this provision of the bill is not a duplication.

When we had requested a preexamination conference, we were not granted it.

A 1-year time limit would have been very helpful. We were in a cooperative mode. Our audit lasted 2½ years. It started in March 1979. It was November 1979 before we had notice from the Regional Commissioner that we were going to be audited. We had cooperated and even sent our 1978 financial statement, and reams of material in the preexamination process.

Well, from November 1979 to June 1980 we tried to schedule an audit. We were unable to do so. The agent changed the date three times. He started the audit, which lasted 5 weeks, and after being there 2 weeks, he quit and went on vacation, which made us very upset because we were trying to get the thing over with. He said he didn't know when he would be back. We called the supervisor asking for him to come back. And we concluded it in the end of July 1980.

July 1980 until October 1981 we waited. And I think the 1-year time limit or provision which would make it incumbent upon the IRS agency to deal expeditiously with churches would be very helpful. The recovery of legal costs, of course, would have helped as well.

Senator **Grassley**. Also, Mr. Coleman, the IRS is maintaining that their exemption organizations division tries to assist taxpayers and create a nonadversarial atmosphere. What was your experience with the IRS? And will these procedures, in your view, increase the adversarial nature of the audit process?

Mr. **Coleman**. Procedures proposed by S. 1262 would not increase the adversarial nature in my opinion. They would decrease it. Our personal experience would indicate that the higher up the rank we went in Internal Revenue Service the more responsible and conscientious the official became.

I would like to point out that overseeing an agency or any corporation with 80,000 or more employees there is no way to assure that procedures which may be properly designed at a high level will be implemented practically as they were designed. And we found numerous violations in terms of implementation.

I believe because the procedures would be defined in statute that the accompanying role that a church could take with the IRS, if they are a legitimate church, would be that of their being better informed. If they are willing to cooperate, they know what they are cooperating on. They know the potential consequences, and I think it would have helped legitimate churches engaged in such adversarial examinations.

Senator **Grassley**. Mr. Williams, both you and I share a concern about Government intervention with religious activities. In our modern society, many individuals are mimicking religious form to claim tax benefits. That was laid out well by both Mr. Pearlman and Mr. Egger.

How can we best address the threat to religious freedom yet stop the unlawful form of religious use when its main purpose is the avoidance of tax?

Mr. **Williams**. Sir, I believe the tools are already in place through Federal criminal codes; tax evasion, and tax fraud are crimes. And I believe that through basically the means that the 15,000 tax protester cases have come to the attention of the IRS today. Whatever those means are. However, they come to the attention of the Internal Revenue Service.

In every case where there is probable cause criminal prosecution would be appropriate. And I believe that that in conjunction with the proposed Senate bill 1262 the evidence requirements would be sufficient to preclude the tax protester elements, to arrest that problem, if you will, and at the same time to allow protection for legitimate churches and church organizations.

I believe we do have to be careful in how we define a church. And we must be careful in not too narrowly defining a church to be a building with bricks and steeple and so forth. But essentially what we are looking at is an organization, a group of people gathered together to further the practice and exercise of their faith. And where those elements are present, there is no need for further investigation.

One example that I'm familiar with by word of mouth involves the Christian Liberty Church in Milwaukee, Wis., where for some reason the church came to the attention of the Internal Revenue

Service. And I am told that one of their agents as part of his investigation did what I think is a reasonable thing. He went to the church. He went to a church service. He saw the worship service. He saw the pastor. He talked to people in the church. And he concluded on his personal level that this was a legitimate church. And I would say at that point that that investigation should have terminated.

On the other hand, if it comes to the attention of IRS through these mail order churches materials, for instance, bulletins advising the people how to beat Uncle Sam, or how a mail order church can be set up—I think the bad faith of that situation is obvious. I fail to see that there would be any real problem in prosecuting those kinds of cases.

Senator Grassley. Again from your standpoint of studying religious activity in this country and being concerned about it, and particularly from the historical perspective considering 200 or 300 years where there has been off and on again State intervention in churches, are the current enforcement actions of the IRS more or less intrusive than past Government encouragement if you look over the broad history of our church-State relations?

Mr. Williams. I think historically viewed much more intrusive. I think the words of——

Senator Grassley. It's much more intrusive today?

Mr. Williams. Yes. I think the words of Senator Bennett when he was introducing the original section 7605(c) point that out. That prior to 1969 churches could have the unrelated business activities, for instance, without any consequences. And, historically, the attitude has been one of total hands off. It has only been in the last 30 or so years that that attitude has changed.

Senator Grassley. And, obviously, in our testimony in support of this legislation you feel that it is going to help define governmental interference and curb that with legitimate church activity?

Mr. Williams. Yes, sir, I do. I believe the point that Mr. Coleman made was well made. That by putting it in the statute so that it is there for everybody to see, the churches will know what their rights and duties are, as will the IRS, and when the rules of the game are laid out up front, I believe it will make a more cordial relationship and contact where contact is necessary. And it will avoid unnecessary contact.

Senator Grassley. Mr. Liken, could you come over to this microphone, please? You recall from Treasury's testimony that even though they support the objective to the bill they have some fear about what the bill might do to encourage further tax protest movements, tax protestors generally. You almost feel that they are unconvinced that a problem exists. When you were a regional counsel, as I said in your biography that you were, did you perceive a problem with church audits?

Mr. Liken. No.

Senator Grassley. You did not.

Mr. Liken. On the other hand, I believe that the tax protest movement has gained considerable force in the past few years. I do believe that the concern which was expressed by Treasury is a very valid concern. And I think it's something that the committee needs to consider very carefully, and to build some kind of safeguards around it. After all, I think that what we are trying to do here is to make sure that if this is a legitimate church that there is sufficient communication between the parties for that to become apparent, but that we are not providing some kind of avenue for an individual to obtain church status or retain it which is not merited. And perhaps some sort of an exception to the procedure in the case of fraud or something like that would be indicated. I think that needs to be considered very carefully. I think they voiced a legitimate concern.

Senator **Grassley**. As a private practitioner, what type of abuse cases have you witnessed? And also would the provisions of this bill have prevented some of those abuses? And if so, how?

Mr. **Liken**. I was one of the four attorneys in the *Gulf Coast* case which has been discussed here today. Now let me say something about that. The church answered two series of very, very lengthy questions. They answered them fully, completely, accurately. They explained everything. They delivered every document. They did everything that could possibly be done. But they were audited.

Now following the examination we pursued a Freedom of Information action, which was kind of costly but we found out why the church was examined. The FOIA materials disclosed there was some reason for the Internal Revenue to have raised concerns. And if the questions IRS asked the church had gone to those concerns, they could have been answered very clearly, very quickly, very promptly without all of that expense.

But the questions were either boilerplate or did not go to the heart of what was bothering the Internal Revenue. The letter from the district director to the regional commissioner wherein the district director recommends this examination gets into facts which were never brought up in the correspondence with the church. The church was never asked about it.

And that is the reason that I think that if the parties get across the table from each other and talk it out, and if Internal Revenue has to set forth exactly what is bothering it, maybe this kind of a thing will not happen in the future.

Senator **Grassley**. I think that's a strong statement from people that have been involved. And you have been involved on both ends as an enforcer of the tax laws and now as a defender of those who are being abused.

Mr. **Liken**. That's correct, sir.

Senator **Grassley**. Also to you, Mr. Liken, is it the requirement that the regional counsel approve a request for examination an important safeguard? Now you did speak to the point that you didn't think that it had to have concurrence.

Mr. **Liken**. Yes.

Senator **Grassley**. But just submitted for his review.

Mr. **Liken**. Yes, I think it's very important. And, again——

Senator **Grassley**. So you agree that he ought to be involved more early than he is at this point?

Mr. **Liken**. Exactly. And let me make a point there about this case that we are talking about. Eventually, the District Director referred the case to regional counsel for review after he had announced to the church he intended to take away its exempt status.

Now the District Director did not have to do that, but he did and he should be commended, if he ordered it. And the regional counsel studied the facts and the issues thoroughly over a pretty considerable period of time and concluded that this case should be dropped. And it's to the credit of the regional commissioner that he did exactly that.

Senator GRASSLEY. Again, from your experience——

Mr. LIKEN. But if we had had this up front, see, it's very likely that the case would never have gotten to where it got.

Senator GRASSLEY. All right. Again, from your experience in that position as a regional counsel, do you think that this additional requirement that this bill puts on the regional counsel is going to be too time burdensome?

Mr. LIKEN. Oh, no. It's insignificant in the totality of their operations.

Senator GRASSLEY. Also, Mr. Liken, one of the provisions of the Church Audit Procedures Act, which you have expressed reservation about, is the injunction section.

Mr. LIKEN. Yes.

Senator GRASSLEY. Do we need to define when it is appropriate to seek an injunction? Is that the problem?

Mr. LIKEN. I do not understand that provision. I do not, at this time—I cannot say that I like that provision. It seems to me that it introduces into the tax law some of the technicalities that we see—some of the technical approaches that we see in the criminal law—where they are splitting very fine hairs. In taxation we have gone on the basis of substance and not on form, particularly in procedural matters.

I do not understand why the provision is there. I do not think it is an appropriate provision. I hate to see that kind of technicality introduced into the tax procedure.

Maybe someone will explain it to me. But as I see it now, I do not favor that provision.

Senator GRASSLEY. Well, then let me ask you on the same provision. Would it be improved if an injunction could be sought only for procedural violation of the act rather than a disagreement with a substantive issue, such as the sufficiency of evidence to initiate an examination?

Mr. LIKEN. Yes. The sort of thing that occurs to me that might happen here—say Internal Revenue came in and said the facts are tweedle-dee and assume that the facts turned out to be tweedle-dum. Could they enjoin the Internal Revenue? I don't know.

What if the Internal Revenue saw the issue as *x* issue, but along the line it turns out that it is not *x* really; that it's *y*. Can they enjoin the Internal Revenue?

Now relating that back to standard tax procedures such as the issuance of a statutory notice of deficiency to give you a feel for the way taxation operates in this country, a statutory notice of deficiency must state a year and an amount of tax deficiency. It also gives a reason for it. But if that reason is incorrect, that does not invalidate the statutory notice of deficiency. And I would hate to see taxation get to the point where we are splitting the difference between tweedle-dee and tweedle-dum.

Senator **Grassley**. I know that's very difficult. And I guess maybe the longer you think about it and visit with me and staff of the committee maybe we ought to have further counsel with you on that.

Mr. **Liken**. I certainly would welcome someone explaining it to me.

Senator **Grassley**. All right.

Also, Mr. Liken, the Treasury and the IRS are concerned that the definition of evidence is vague and will hamper their enforcement efforts against tax shelters. Now in your testimony you echo those same concerns. What changes should be enacted to improve the bill from that standpoint—the evidentiary threshold or even the use of the word "evidence."

Mr. **Liken**. I think perhaps the use of the word "evidence" would be unfortunate. And I would say that if the bill were to say something to the effect that the regional commissioner has "facts and information" which leads him to believe that there may be a violation—rather than evidence there is a violation—it would be satisfactory. I don't see how he can believe that there is a violation when he doesn't have the evidence yet. But he can say the facts he has suggest that there may be a violation. I think that is really what is intended by the proposed bill. In other words, we are not seeking to build some kind of procedural sanctuary.

Senator **Grassley**. All right.

And my last point with you, Mr. Liken, again gets back to your examining this legislation. And from your doing that, I would like to have in as specific a way as you can to tell me whether or not you think there might be a tendency in the Internal Revenue Service to define "church" very narrowly by the regulations.

Mr. **Liken**. I do not know whether I can answer that question. I have not thought about it, Senator. I'm not sure that I really understand the question. But I feel that Internal Revenue has probably defined some things as churches that I wouldn't define as a church.

Senator **Grassley**. All right.

Mr. **Liken**. I'm a rather strict constructionist religiously.

Senator **Grassley**. Mr. Dugan, I have got a few questions for you. I think I have 6 minutes before I have to go to vote. That gives us 15 minutes.

You represent a large organization of churches, as you have already alluded to. But also I think I would be precise in saying many of your churches tend to be relatively small. In your 5 years as director, how many specific cases can you recall of your members being subject to an IRS audit? And in those cases, what was their experience with the IRS? And, also, what provisions of this legislation would be most helpful to you in preserving the constitutional rights of your members?

Mr. **Dugan**. Mr. Chairman, I don't have any handle on the number of the churches that may have been involved in audits by the IRS. Those churches would not necessarily report such facts to us. And I presume some of them, in the spirit of Christ suffering even in well doing, might well have suffered in silence and complied beyond reasonable requests and endured all that and had their names cleared or vice versa, whatever the outcome may have been.

So I don't know that any other than this one particular case has been brought to our attention during that period of time. But my spirit of approach on this kind of an issue is that an ounce of prevention is surely worth a ton of abuse in the long haul. So if it could happen to one church, as it did—and we had that personal acquaintance with the Gulf Coast Covenant Church—why, we would like to see others protected from that possibility.

But I really have no statistics. A certain number of ours, certainly by all odds, would have been included in the auditing procedure.

Senator GRASSLEY. What are the most common problems your members encounter with the IRS during preexamination audits? And I suppose, then, that your answer would have to reflect back to the only one case that you have had brought to your attention.

Mr. DUGAN. That would be a hypothetical. So from that one case I can answer specifically. But since I don't know of other cases—it seems to me that several of these provisions would be a protection, and Michael Coleman has enumerated some of this specifically. And that would be my best response, to underscore those from his experience.

Senator GRASSLEY. Well, maybe a more general question would be appropriate to you. In your 5 years with the organizations or your 20-some years as a minister yourself, is this sort of thing mentioned at your national meetings or your regional meetings or come to you in correspondence even though you don't have specific examples?

Mr. DUGAN. Ah, yes.

Senator GRASSLEY. It is a fear expressed.

Mr. DUGAN. Yes. One reads articles from time to time about—giving horror stories. And there is a concern along the line. And I think that the very significant request for information about this act, when we mention it—and really without florid prose—indicated that people are concerned about the potential. And I think quite properly the IRS has been more active in this area because of the abuse—the mail order ordinations and so forth.

I well remember in Colorado in 1978 when there was an independent candidate for Governor of that State who was himself perpetrating one of these things. He declared himself a minister and then used all of the proceeds of his interior decoration business to go to the church from which he was paid expenses. And, thus, allegedly had no income whatever. How offensive that was to me that he would be denigrating the ministry and the churches in general by such an obvious fraud. And, in fact, we called him on it in a political meeting one time when he was appealing for support.

So people hear these kinds of stories and we say the IRS ought to sort out such abuse of the laws. But because that is happening then innocent churches, which are churches by anybody's definition of the term, are subject to the potential. And so there has been conversation about that.

Senator GRASSLEY. So then even though you come to us knowing only of the one specific case, this thing has gone on in Alabama, there is broad concern expressed through your organization by your individuals, and you personally know of this concern.

Mr. **Dugan**. That is correct. Yes, sir.

Senator **Grassley**. I appreciate very much your presentations. But most importantly because so many of you have had individual experience with the concerns that this bill tries to address. It makes it much more real as we approach the legislation and consider the need for it.

I will say thanks and ask you to depart.

I will announce to the next panel that according to estimation there is just this one vote at this time. So I will go vote. And that will take about 10 or 12 minutes. And then I will come back, and we will immediately start with the next panel.

If I'm bothered with a multitude of votes after that, I will give panel members an alternative that maybe would fit their schedule. I personally want to hear your testimony and will take whatever time it takes after the votes to do that, if you can.

If the individuals on the last panel have time constraints that does not allow them under that unpredictable environment to stay, I would allow you to give your testimony to the staff. And the staff can ask the questions that I perceived needed being asked from the review of your testimony.

So you can consider how you want to do that if we are interrupted at a future time.

The meeting will recess then until about 12:07.

[Whereupon, at 11:56 a.m., the hearing was recessed.]

AFTER RECESS

Senator **Grassley**. That last panel is four people. They are Mr. Lehrfeld, Mr. Kelley, Mr. Borden, Mr. Gutman. I hope you can come now.

Mr. Lehrfeld practices law here in Washington, and includes among his clients numerous religious organizations. Before entering private practice, Mr. Lehrfeld served in the Internal Revenue Service for 6 years in the exempt organizations division. He is author of over 30 articles on the tax treatment of exempt organizations.

Dean Kelley is the director of the religious and civil liberty's project for the National Council of Churches. Reverend Kelley has been an ordained minister of the United Methodist Church since 1960. He is the author of several books and magazines on the subject of taxation of churches and Government intervention in religious affairs.

Mr. Borden is the executive director of the Evangelical Council for Financial Accountability. And that is located here in Washington. He has served in that position since 1981, and is responsible for all the Council's operations. Mr. Borden has a BA from Kings College and holds a masters in theology from Dallas Theological Seminary.

And Jeremiah Gutman—I hope I'm pronouncing that right.

Mr. **Gutman**. You are right on, Senator.

Senator **Grassley**. He is here today testifying on behalf of the International Coalition Against Racial Intolerance, a group which monitors interference with religious freedoms throughout the world. He also serves as the president of the New York Civil Liberties Union. He is the director for the American Civil Liberties Union and chairman of the ACLU Privacy Committee. In addition to participating in the civil liberties movement for over 30 years, he is a partner in a New York City law firm. He counts among his clients many of the less popular religious groups.

Between authors and outstanding lawyers, this is a pretty prestigious panel. I appreciate all of you contributing to us the knowledge of your research and practice.

Would you proceed, Mr. Lehrfeld, and then right down the line.

STATEMENT OF WILLIAM J. LEHRFELD, LEHRFELD & HENZKE, WASHINGTON, D.C.

Mr. **Lehrfeld**. Thank you, Mr. Chairman.

My name is William Lehrfeld, of the firm of Lehrfeld and Henzke. I want it said at the outset that this testimony is delivered solely on my account, and should not be regarded as testimony of any church or religious society which our law firm represents. I'm not authorized to speak on behalf of any organization on this bill.

I would like for a minute to depart from my prepared testimony to make a suggestion to the Chair and perhaps to the prior witness panel. That is, if the audit by the Internal Revenue Service of the Gulf Coast Covenant Church is to be a paradigm for national legislation affecting all church organizations, the hearing should get both sides of what actually happened. Therefore, I suggest that the church, through its appropriate officers, waive its right to privacy to its tax return and tax return information so the Internal Revenue Service's review of the examination could be submitted for evaluation by the committee or staff. As it presently stands, there is a question whether or not the secrecy laws governing tax return information could permit effective consideration of what actually occurred since you don't have the views of the auditing agency.

That said, I would like to point out at least in my judgment that the bill is flawed from a tax policy standpoint; it's flawed from a technical standpoint; and it creates in my mind substantial constitutional questions which are better left unresolved at the present time.

Stated most succinctly, the bill gives an association of religiously inclined individuals far greater rights respecting the association's accountability under the Internal Revenue laws than the sum of all of the members. There is no justification in mind under either the Internal Revenue Code, its administration or the judicial decisions that have resulted from the use of the various authority that is already in the code that there has been any substantial abuse that cannot be rectified by and within the agency.

Now as to some particular points, Mr. Chairman; As you know, our income tax laws have inclusions and exclusions, exemptions and credits, deductions and checkoffs, carry backs and carry forwards all as part of an elaborate balancing of competing economic, social and political interests. All abatements of tax are, up to a point, borne by those who have the fewer benefits.

It is not wrong for those who are so burdened by additional tax to have the right to ask for accountability from the beneficiaries of reduced taxes. This bill, in my judgment, thwarts the opportunity for those administering the tax law to report to the burdened the total cost of church tax benefits. In my mind, promoting non-accountability is shortsighted from the church's standpoint, and an obvious slap in the face to all auditable taxpayers who pay their fair share of taxes.

In addition, the bill permits churches to hide from legitimate law enforcement. And the bill adds to the plausible public suspicion that to some scoundrels, their last refuge is in churches.

Moreover, the bill distorts the allocation of all audit resources by accentuating procedural safeguards, the failure of which to observe provides for disproportionate penalties against the auditing agency, and, therefore, the taxpaying public.

A procedural check on the Internal Revenue Service is directed towards churches, a word undefined, now and probably later, by law or by Internal Revenue regulation. It invites vigorous action by the Internal Revenue Service to find a judicially viable set of criteria so that it will know or not know when any audit target is, in fact, and in law, protected by your proposed legislation.

If we paraphrase, for a definition, one of Mr. Justice Stewart's famous opinions when he sought to define pornography—we know a church when we see it—that doesn't mean that we can define it explicitly. We know a diocese of Catholics; We know a synagogue of Jews, and we know steepled institutions of major Protestant denominations. But what of the storefronts, those alienated from theism, the flocks of believers who congregate without official seal or staff or scepter.

It seems to me your legislation invites much provocative and disstablement for the unorthodox, the out of the mainstream, and the reawakened who may gather in the name of a Larger Presence, but without any administrative blessing. It is their kingdom, and their religious freedom, that is threatened by this bill.

Thank you, Mr. Chairman.

Senator GRASSLEY. I won't explore now, but on top of it, what you said there at the last, it would be those groups that are out of the mainstream that we would foresee being potentially harassed or maybe having actually been harassed that we do want to protect. And you are saying that you think our legislation threatens that.

Mr. LEHRFELD. Yes.

Senator GRASSLEY. All right.

[The prepared statement of William Lehrfeld follows:]

LEHRFELD & HENZKE, P. C.
A LAW CORPORATION
SUITE 1110
1301 PENNSYLVANIA AVENUE, N. W.
WASHINGTON, D. C. 20004
(202) 659-4772

WILLIAM J. LEHRFELD
LEONARD J. HENZKE, JR

PREPARED STATEMENT OF

WILLIAM J. LEHRFELD

LEHRFELD & HENZKE, P.C.
1301 PENNSYLVANIA AVENUE, N.W.
SUITE 1110
WASHINGTON, D.C. 20004

ON

S. 1262

"THE CHURCH AUDIT PROCEDURES ACT OF 1983"

DATED, SEPTEMBER 30, 1983

LEHRFELD & HENZKE, P.C

A. Introduction

My name is William J. Lehrfeld, of the firm of Lehrfeld & Henzke, Washington, D.C. Our firm represents numerous non-profit organizations including a considerable number of religious societies, churches and associations of churches. It should also be noted that the undersigned spent 6 years with the Internal Revenue Service, Exempt Organizations Branch, and in that capacity was responsible for numerous cases and ruling requests relating to the tax status of churches, and associations of churches.

This testimony is delivered solely on my account, and should not be regarded as the testimony of any church or religious organization which our office represents. I am not authorized to speak on behalf of any organization on this bill.

In general, S. 1262 imposes several conditions precedent before the Internal Revenue Service may undertake an examination of an organization claiming to be a church (undefined by law). It establishes elaborate bureaucratic procedures for pre-audit review within the auditing agency, provides for two sets of notification requirements, statements of rights (undefined by law) together with two separate statements on the evidence available to the Internal Revenue Service justifying the examination. The examination provision also bars the Internal Revenue Service from church records except to determine possible unrelated business income tax and imposes a time barrier to future substantive action requiring all of these procedural conditions, and the ensuing examination, be concluded within one year, subject to certain tolling provisions. The bill protects all churches by allowing the statute of limitations to run as to any possible past tax liability, without the concurrent responsibility to file any relevant return in connection with any such tax. Finally, the bill accelerates the judicial review process, involving declaratory judgments, by not requiring the church to exhaust its administrative remedies prior to petitioning a court of competent jurisdiction for a review of the Secretary's revocation action on any ruling to the church on its tax exempt status.

Mr. Chairman, in my opinion, the bill is flawed from a tax policy standpoint, flawed from a technical standpoint, and creates substantial constitutional questions which are better left unresolved at the present time.

Stated most succinctly, this bill gives an association of religious individuals far greater rights respecting its accountability under the tax laws than any individual member of that association. There is no justification whatsoever, under the current Internal Revenue Code, and its administration, to give religion, despite its constitutional privileges, the relief contemplated by this bill.

B. Invitation to Mischief

As the summary indicates, this legislation is an invitation to mischief and should not be enacted. The elaborate schemata created by a revised Sec. 7605(c) is not really a serious attempt at assuring that there is an orderly process for the review of the activities of a tax exempt organization known as a "church". In reality, it is nothing more than an attempt to bar the Internal Revenue Service from the normal, lawful, and regularly approved methodology already in the law, for the examination of the exemptions, deductions, credits and benefits which are extended to church organizations, their ministers and members either by reason of their being religious organizations (IRC Sec. 501(c)(3)) or by reason of their being "churches" (IRC Sec. 6033(a)(2)(A)).

The investigatory process apparently contemplated by the revised law requires first that there be "evidence" which leads the principal revenue officer for the Internal Revenue region in which the church is located to "reasonably believe" that the church is engaged in unrelated trade or business activities or that the church is not exempt from income tax under Sec. 501(a). The technical flaw in this latter situation is that an organization which is a church is exempt from tax not because it's a "church" but because it is organized and operated "exclusively" for "religious" purposes. Stated otherwise, a church is exempt from federal income tax under Sec. 501(a) and Sec. 501(c)(3) not because it is a "church" whatever that definition may be in law, lore, or divine prophecy, but because the organization has met the four statutory criteria for the income tax exemption stated in the descriptive paragraph of Sec. 501(c). The organization's benefits as a "church" are not contained in Sec. 501(a) or Sec. 501(c). Next, after the Internal Revenue officer possesses this evidence and concludes that an investigation should be undertaken of the specific church, that officer must submit the recommendation for examination of church records and religious activities to the Regional Counsel of the Internal Revenue region for review and receive the Regional Counsel's concurrence.

Prior to obtaining Regional Counsel concurrence for instigating the investigation, the church is given pre-investigation notification and the opportunity to meet with the Internal Revenue officers to discuss facts, evidence and issues. After the conclusion of the pre-investigation notification, conference opportunity, and the subsequent submission for Regional Counsel concurrence, the organization is expected to receive the written notice of the commencement of the investigation and that written notice must give the organization at least 15 days advance warning and contain a description of records and activities sought to be reviewed in the investigation.

The Internal Revenue officer must notify the church organization through a written notice that an investigation is being commenced and the notice must contain (1) a list of statutory provisions governing the proceeding, (2) an explanation of the "rights" provided for by the Constitution and the Internal Revenue Code, (3) an explanation of the concerns (undefined) which gave rise to the investigation "the factual issues" relevant to the case and a description of all the "evidence discovered" to date and lastly (4) a "clearly worded" statement of the facts which the Internal Revenue officer expects to determine.

From a technical standpoint, assuming that each of these somewhat inconsistent steps in the examination process can be merged into one sensible approach the organization is given two notification opportunities, an elaborate appeal procedure, a right to protect its records which it claims relate to its religious activities, and the Internal Revenue Service is left with the responsibility of establishing that it has satisfied all the disclosure requirements with respect to its information on the organization. If the Internal Revenue Service is perceived to have erred procedurally, the entire civil audit process can be halted by a civil action to determine if the agency followed the procedural formulation of the bill.

I have reviewed all reported federal court decisions which cited IRC Sec. 7605(c), from United States v. Luther, 481 F.2d 429 (9th Cir. 1973) to United States v. Coates, 692 F.2d 629 (9th Cir. 1982) and find no pervasive procedural irregularities in Internal Revenue Service audit practices of churches, congregants or ministers. Absent judicial calls for procedural reforms, or official government reporting of failures within the current system for auditing all taxpayers, churches included, no case has been made for Congressional action. Neither isolated instances of alleged procedural abuses, nor hyperbole, nor the opportunity for the exercise of government de-regulation, justifies the intrusion by this subcommittee of 70 years of carefully conceived, evaluated and implemented the audit process, even for a Constitutionally protected purpose as freedom of religion.

That said, my critiques of the procedural parts of the bill include:

(1) Our income tax law has inclusions and exclusions, exemptions and credits, deductions and check-offs, carrybacks and forwards, as part of elaborate balancing of competing economic, social and political interests. All abatements are, up to this point, borne by those with less benefits of any form, than legislated interest; those who are burdened by additional taxes have the right to ask for accountability of the beneficiaries of reduced taxes. This bill thwarts the

opportunity for those administering the tax law to report the total costs of church tax benefits--which is shortsighted from the churches standpoint and an obvious slap in the face to all auditable taxpayers who pay their fair share for our common interests in government.

(2) The bill permits churches to hide from legitimate law enforcement--which may suggest that if they desire to use the law to hide from accountability and law enforcement--they in fact are not as law abiding as the public--which now supports their tax free status--believe they should be. There is enough publicity already on mail order ministries, and tax avoidance churches, to shake public confidence in our preferred institutions. This bill adds to the plausible public suspicion that to some scoundrels, their last refuge is in churches.

(3) The bill distorts the allocation of all audit resources by accentuating procedural safeguards the failure of which to observe provides for disproportionate penalties against the auditing agency and, therefore, the taxpaying public.

(4) This procedural "check" on the Internal Revenue Service is directed towards churches, a word undefined now (and probably later) by law or regulation. It invites a most vigorous action by the Internal Revenue Service to find a

judicially viable set of criteria so it will know[1] or not know[2] when any audit target is protected by your new IRC Sec. 7805(c). We know dioceses of Catholics, synogogues of Jews, and the steepled institutions of major Protestant denominations. But what of the storefronts, those alienated from theism, the flocks of believers who congregate without seal or staff or scepter. Your legislation invites much provocation and dis-stablement for the unorthodox, the out of a mainstream, and re-awakened who may gather in the name of a Larger Prescence, but without judicial blessing. It is their kingdom, and their religious freedom you threaten--simply to preserve your preserve.

(5) The bill bars the compliance audit, using a random selection of a tax exempt organization's for audit, and thus deprives the administrative agency of a useful tool for gathering information on how, and to what extent, churches generally comply with the provision of exemption.

1/ IR-1930, Remarks of Commissioner, January 9, 1978, on difficult definitional problems in tax code; Whelan, "Church" in the Internal Revenue Code, 45 Fordham L.R. 885 (1977).

2/ GCM 38982, IRS Doc. CC:EE-12-82, holding a radio ministry is not a church under IRC Sec. 170(b)(1)(A)(i).

(6) The bill will have the effect of delaying resolution of truly valid, substantive problems arising under the Internal Revenue Code provisions affecting church benefits since too much time will be involved with procedural niceties, and there will necessarily follow delayed efforts at rectifying non-compliance with existing law.

Example: A minister, from his church's pulpit, exhorts his congregation, in October 1984, to elect John Doe, President and to participate fully in all campaign activities to that end. Because of the annual accounting concepts of the tax law, Internal Revenue Service efforts to challenge the church's tax exempt status immediately could easily be thwarted thereby inviting wholesale disregard of the existing law's limit on political campaign activity.

(7) By setting up a wholly preferred class of beneficiaries, it invites more rigorous--negative--evaluations of now undefined terms and conditions in existing law so that the privileged few are limited in size, number, scope and influence. This is an unhealthy tilt in the administration of laws governing charitable, religious and like organizations.

C. Statute of Limitations

Under existing law, an exempt organization files an exempt organization information return (IRS Form 990) stating, in particular, its sources of income, its expenses, and otherwise describing its financial condition. See, IRC Sec. 6033(a). It is also obliged by law, if it earns unrelated business taxable income, or if it is liable for the political activity tax, to file other returns and pay the tax with the return. The Tax Court, and now the Internal Revenue Service, recognized that when an organization files a completely descriptive information return, required by IRC Sec. 6033, that information return is a "tax return" for purposes of applying the statute of limitations. See California Thoroughbred Breeders v. Commissioner, 47 T.C. 335 (1967) as acquiesced in by Rev. Rul. 69-247, C.B. 1969-1, 303.

Prop. Sec. 6501(r) gives churches the protection of the statute of limitations without the concomitant responsibility of filing any tax return, or even an information return, despite the obligations imposed by our self assessment system; it sets up a separate criteria for any situation in which a partial payment of a tax liability may be made, apparently without a return, and bars assessment of the remaining liability if the assessment is not rendered before the expiration of three years after the date on which such partial payment was paid.

This particular provision is egregious over-reaching by church organizations since they seek for themselves protections of the statute of limitations which they can have by filing a return. Returns are evaluated to determine final liability, and make corrections for underpayments or overpayments of estimated tax payments. All adjustments to liability have been through returns in order to evaluate correctness. The integrity of the entire system depends upon returns being filed in a timely, complete and correct manner. Limitations on assessments are enacted to bar stale efforts to re-work liability or refunds and acts as a medium to assure efficient allocation of government resources. There is no justification whatsoever for a time barrier to assessment if no return is required to be filed. It is at best, an attempt to provide an immodest time limit for those taxpayers who are not now required by law to file an information return and at worst an opportunity for a certain limited class of tax exempt organizations to thwart, in its entirety, the entire self assessment system contained in the Internal Revenue Code, through fraud, negligence or ignorance.

D. Declaratory Judgment Review

Revised Sec. 7428(b)(2) permits a church to bypass the administrative appeal procedures before petitioning a court for a declaratory judgment on its status as a tax exempt organization. While there is much sense in accelerating the opportunity of any exempt organization to judicial review by not passing through the administrative review process of the Internal Revenue Service, this provision is technically flawed. The declaratory judgment provisions now in Sec. 7428 apply only with respect to a determination of the organization's tax exemption (IRC Sec. 501(c)(3)) or classification (IRC Sec. 509(a)) by the rulings process. The law does not grant jurisdiction to review possible liabilities for any unrelated business taxable income. (Ohio Cty and Ind. Agr. Soc. Del. Cty. Fair v. Comm'r, 610 F.2d 448 (6th Cir. 1979)). Moreover, there is no requirement now in the law that any exempt organization, church or otherwise, exhaust its administrative remedies prior to pursuing a challenge to the Internal Revenue Service's preliminary, tentative or actual findings of a deficiency in the unrelated business income tax.

The proposed statute is also flawed because it presumes that the Service may "revoke" the organization's "status as a church". The Internal Revenue Service simply has no authority to do that. All the Internal Revenue Service may do is revoke a private letter ruling which recognizes that it had previously agreed the organization was a "church". The Internal Revenue Code itself, not any private letter ruling or administrative action, determines if an organization is a "church". Thus this particular section, as it is presently worded suggests that it is Internal Revenue Service which finally determines whether an organization is a church. That is not the law.

The proposed amendment also implies that the organization need not have a private letter ruling which is the subject of revocation in order to have access to the declaratory judgment procedures for judicial review. Because substantially all churches in the United States do not hold individual private letter rulings recognizing their tax exempt status, the normal revocation procedures would not be applied if a church is found not to qualify for tax exempt status since there is nothing to revoke. Your language therefore implies that there may be access by a church, to judicial review under Sec. 7428, if the Internal Revenue Service simply tentatively determines non-compliance with tax exemption or church classification requirements and then initiates proceedings in the normal manner to assess tax against its audit target because the church does not have a private letter ruling recognizing (not establishing) its status.

In summary then, while it is a good idea to provide all exempt organizations holding private letter rulings which are the target of revocation by the Internal Revenue Service the opportunity to accelerate access to judicial review by their conscious waiver of the administrative appeal process (now required by Sec. 7428(b)(2)) the provision as drafted, when applied to churches, for the reasons stated above, is technically deficient.

STATEMENT OF REV. DEAN M. KELLEY, DIRECTOR, RELIGIOUS AND CIVIL LIBERTY, NATIONAL COUNCIL OF CHURCHES OF CHRIST IN THE U.S.A., NEW YORK, N.Y.

Senator **GRASSLEY**. Reverend Kelley.

Reverend **KELLEY**. Yes, sir. In addition to my written testimony, I would like to highlight that and make a couple of points arising out of the experience of the National Council of Churches, which is one of the mainline bodies. It contains 30 denominations, national religious bodies with an aggregate membership of over 40 million.

At the time that Senator Bennett offered his amendment designed to safeguard the religious liberty of churches, the National Council of Churches was experiencing an audit by the Internal Revenue Service, which is why it lingers in our memory.

The auditors had entered the premises when the bill was passed. Because of the Bennett amendment, they withdrew for a period of several months, apparently under the impression that it meant what it said. However, wiser heads prevailed in Washington, and they were back again, telling us that the Bennett amendment did not really preclude their continuing the audit.

They were proceeding with the permission of our finance office and with the general unawareness of the rest of the council until we arrived at our particular program unit and requested a copy of all of our minutes and publications. Somewhat alarmed at this, I asked our financial administrator if he had consulted legal counsel. He hadn't. He called Judge Tuttle, our general counsel of the firm of Breed, Abbott, and Morgan, who was vacationing at Lake George, who returned immediately to the city; examined the situation; and told the IRS to get out, which they did.

Over the ensuing months, we met in conference with the District Director repeatedly. We exchanged lengthy communications by mail, setting forth our contentions, which were eventually answered by the District Director who said, in effect, that because the Treasury had finally issued regulations interpreting 7605(c) our doubts could now be resolved, and they could continue the audit. And if they did not continue, they could not give advance assurance of deductibility of contributions to the National Council of Churches, which some might conceive to be a rather veiled threat.

We had protested those regulations, as a matter of fact. Rather than their resolving our doubts, they increased them. Our objections being that the Treasury regulations effectively nullified the intention of Senator Bennett and the Congress.

Nevertheless because of the implied threat and because we had actually had them in the premises for a number of months before we asked them to leave, we let them back in under arm's length restrictions that they not act on the premises; that they request evidence in writing, some of which we supplied, some of which we declined to supply because it wasn't our property, et cetera. And after a certain amount of additional give and take and the expenditure of hundreds of hours of our time and theirs, and thousands of dollars in legal fees, they sent us a one lined mimeographed letter saying the audit is completed and your tax status remains as it was.

Now the chairman mentioned at the beginning of the hearing the phenomenon of capricious meddling by the IRS. I hope that this bill would help to deal with that problem. But I'm even more concerned about noncapricious meddling.

I would like to say, though I can ill spare the time, that we felt the IRS in our experience with it was uniformly courteous and reasonable, if you granted their assumptions, which were that they had a right to audit all the activities of an exempt entity, including churches—they made no distinction for churches—despite the first amendment's provision for churches, and that they were entitled not just to penalize improper tax conduct, but to remove the exemption in toto.

Now the Tax Code provides a temptation to political administrations—which I mention two instances in the past 20 years—to use the Tax Code as a weapon to punish critics of current administration policy. That happened under the Kennedys to Billy James Hargus Christian Echo National Ministry, as my colleague on my left can well testify, and a decade later under a Republican administration which had a list of target organizations, among which the National Council of Churches was included. And we surmise that that may have been the reason for our audit. And, in fact, we felt that the problem was not at the District Director's levels or at the regional level who seemed actually embarrassed to be doing what they were doing, but at a top level. And I'm not sure how that can be dealt with by legislation.

But we appreciate your intention in the legislation, and urge its adoption after suitably perfecting it.

Senator Grassley. All right.

[The prepared statement of Rev. Dean M. Kelley follows:]

TESTIMONY OF THE
NATIONAL COUNCIL OF THE CHURCHES OF CHRIST
IN THE UNITED STATES OF AMERICA

BEFORE THE

SUBCOMMITTEE ON IRS OVERSIGHT
OF THE SENATE FINANCE COMMITTEE

September 30, 1983

ON THE CHURCH AUDIT PROCEDURES ACT

****

Presented by the Reverend Dean M. Kelley
Director for Religious and Civil Liberty
National Council of the Churches of Christ in the U.S.A.

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My name is Dean M. Kelley. I am Director for Religious and Civil Liberty of the National Council of the Churches of Christ in the U.S.A., a position I have held for twenty-three years. I am also the author of a book entitled Why Churches Should Not Pay Taxes, published by Harper and Row in 1977, which deals with some of the questions posed by the legislation before this committee.

The National Council of Churches is the cooperative agency of thirty-two Protestant and Eastern Orthodox national religious bodies which have an aggregate membership of over 40,000,000. We do not presume to speak for all of those members. We do speak for the Governing Board of the NCCC, a representative body of about 260 persons chosen by the member denominations in proportion to their size and according to their own respective processes.

This testimony is based on the policy statement, TAX EXEMPTION OF CHURCHES, adopted by the Governing Board on May 2, 1969, a copy of which is attached. That policy statement, incidentally, authorized the National Council of Churches to join the United States Catholic Conference in jointly requesting that the exemption of churches from taxes on "unrelated business income" be ended, and it was ended by the "Tax Reform Act of 1969". That Act also contained the "Bennett Amendment", Section 7605(c) of the Internal Revenue Code, inspired by that change in the tax exemption of churches. That section purported to restrict the powers of the Internal Revenue Service in examining churches. As Senator Bennett said when he introduced that amendment on the floor:

> The...amendment refers to what I think is a desirable clarification of the language in the bill which, for the first time, allows the Internal Revenue Service to audit churches. This has not been possible under the previous law. And the language of the bill, I think, is too loose...There is a fear the language would open it up so that the Internal Revenue Service could go through all the church books that pertain to religious activities.
>
> (Congressional Record, S. 15951, December 6, 1969)

His amendment, as it finally appeared in the Internal Revenue Code, reads as follows:

> No examination of the books of account of a church or convention or association of churches shall be made to determine whether such organizations may be engaged in carrying on of an unrelated trade or business or may be otherwise engaged in activities which may be subject to tax under part III of sub-chapter F of chapter I of this title (section 511 and following, relating to taxation of business income of exempt organizations) unless the Secretary or his delegate (such officer being no lower than a principal internal revenue officer for an internal revenue region) believes that such organization may be so engaged and so notifies the organization in advance of the examination. No examination of the religious activities of such an organization shall be made except to the extent necessary to determine whether such organization is a church or a convention or association of churches, and no examination of the books of account of such an organization shall be made other than to the extent necessary to determine the amount of tax imposed by this title.

****

The Bennett Amendment was adopted at a time which served to impress it on the memory of the National Council of Churches. A few months earlier, the Internal Revenue Service had begun what it described as a "routine" audit of the NCCC. When the Tax Reform Act of 1969 became law, the audit was suspended by the IRS because of Section 7605(c). But after a few weeks it was resumed, whereupon the General Counsel of the NCCC, "Judge" Charles H. Tuttle of the firm of Breed, Abbott, and Morgan, advised the NCCC that the IRS lacked authority under that section to continue the audit. The NCCC then asked the IRS to leave, which they did.

After exchanges of correspondence, the officers of the NCCC met with the District Director for New York City and members of his staff on September 18, 1970, at which time the IRS insisted on their right and duty to complete the audit. The General

Counsel of the NCCC resisted on the basis of Section 7605(c), characterizing the audit as a general discovery and "fishing expedition" through the affairs of a religious organization. He quoted the recently-decided case of Walz v. Tax Commission (1970) to the effect that tax exemption "creates only a minimal and remote involvement between church and state and far less than taxation of churches" and concluded:

> Obviously, a roving and unparticularized expedition at the will of the Internal Revenue Service through all the papers and affairs of the National Council would mean and create an involvement between church and state by no means minimal or remote.

(opinion letter of Charles H. Tuttle to the General Secretay of the the National Council of Churches, October 13, 1970)

This letter was in due course forwarded to the District Director, who replied on May 4, 1971 with a nine-page rebuttal of Judge Tuttle's statutory and constitutional arguments. The District Director explained the delay in replying by reference to the newly-promulgated regulations issued by the Department of Treasury to implement Section 7605(c) which -- in his view "have now been published and...largely resolved the doubts expressed by Judge Tuttle," thus clearing the way to resume the audit.

The District Director pointed out that Section 7605(c) did not apply to years before its effective date, and so did not affect the present audit of the NCCC for the years 1968 and 1969. (Judge Tuttle contended that the Bennett Amendment simply codified already-existing law: the First Amendment.)

The District Director explained that the IRS's concern with exempt organizations is much broader than with tax-payers:

> Unlike the examination of business corporations, in which the focus is primarily upon examination of receipts and expenditures and the determination of taxable income, the examination of exempt organizations, because compliance with the conditions of their exemption must be verified, requires an audit of virtually all the organization's activities, including its records and evidences of programs, publications, and personnel functions...necessarily all of the organization's operations and activities will be relevant or material to that investigation.

Then he delicately added that:

> The necessity for Service examination is also evident from the fact that if such examination were prohibited, the Service would not be in a position to continue the advance assurance of deductability of contributions as now provided by IRS Publication 78, Cumulative List of Organizations Described in Section 170(c)....

(letter from District Director to General Secretary of NCCC, May 4, 1971)

(In other words, the NCCC would cease to be listed as an organization entitled to deductable contributions if it did not cooperate. As a matter of fact, the NCCC was omitted from that publication in 1973 - the IRS said "unintentionally").

The regulations which the District Director thought would "resolve the doubts expressed by Judge Tuttle" did nothing of the kind. In fact, the NCCC, along with the U.S. Catholic Conference, the Union of American Hebrew Congregation, the Lutheran Council and other religious bodies had vehemently protested those regulations when they first appeared in The Federal Register of December 17, 1970 contending that the regulations effectively nullified the clear intent of the Bennett Amendment. The regulations construed Section 7605(c) to apply only to determinations of the unrelated business income tax liability of the church,

> and have no application to an examination of the books of account and religious activities of such an organization for the purpose of determining the initial or continuing qualification of the organization under section 501(c)(3) or for any other purpose of the code.
>
> (FED. REG., vol., no. 244, p.19115, emphasis added).

The NCCC had contended in its protest that the IRS failed to recognize the unique Constitutional status of churches under the religious clauses of the First Amendment, and that sweeping examinations of the total range of activity of a religious body permitted by the regulation (and experienced by the NCCC) - far more comprehensive than the examination of tax-payers - created a degree of entanglement between church and state that was indeed excessive, the very opposite of what Sen. Bennett and Congress had intended. Nevertheless the regulations were eventually published in final form that in our view effectively vitiated the statute!

After numerous letters back and forth and additional conferences with the district Director, the audit was permitted to proceed, but at "arm's length". The IRS agent was not to re-enter the NCCC's premises, but to request in writing what documents he wanted and if agreeable to the NCCC, they were provided at "neutral" premises by the NCCC's legal counsel.

Eventually, after the expenditure of many hundreds of man-hours of staff-work and thousands of dollars in legal fees, the NCCC on September 22, 1972, received a one-line, mimeographed letter from the IRS stating that the audit was completed and our tax status was unchanged.

(Throughout this nearly three-year ordeal, although disagreements as to law and procedure were vigorously expressed on both sides, in our experience the IRS personnel were invariably courteous and reasonable, doing their duty as they saw it and respecting our efforts to do the same.)

It is not easy to administer the Internal Revenue Code, especially with the increase of organizations claiming to be churches to qualify as tax-shelters. We appreciate the efforts of the IRS to try to cope with "mail-order ministries" pretending to be churches. But we are even more deeply concerned to protect real churches from the recurrent efforts to use the tax code to punish behavior unpopular with the public or the incumbent administration.

The temptation to do so has been irresistable for at least one Democratic and one Republican administration in the last twenty years. In the early 1960's, Billy James Hargis's Christian Echoes National Ministry lost its tax-exemption because of its opposition to policies of the administration in power at that time. A decade later, Congressional investigation uncovered the fact that the IRS maintained a list of "target organizations", including churches, for whom they wanted to make life difficult because those groups were viewed as "enemies" of the then-current administration.

The present legislation should help to insulate churches from political reprisals for preaching views that are unacceptable to those in political power. It should help to restore the safeguards that were in Sen. Bennett's mind when he offered his amendment, and which Congress thought it was enacting into law before the Treasury nullified that law by regulation.

Thank you for the opportunity to present this testimony.

A POLICY STATEMENT
of the
NATIONAL COUNCIL OF THE CHURCHES OF CHRIST
IN THE UNITED STATES OF AMERICA

TAX EXEMPTION OF CHURCHES

Adopted by the General Board
May 2, 1969

> "The following policy statement is an attempt to deal in non-technical terms with a limited area of tax policy which has a limited effect upon the well-being of society. It is not an attempt to assess the wider and more important ranges of general tax policy, where glaring inequities and gaping loopholes call for moral scrutiny by the churches at the earliest opportunity.
>
> "No brief outline of general principles can do justice to the many unique situations in which the churches seek to minister to minority groups or special populations. If the principles set forth below should have an adverse effect upon any small, struggling churches in the inner city, the rural parish or the Indian reservation, or if the changing nature of the mission of the church should necessitate changes in the traditional concepts of tax-exemption, these policies, like the tax-codes themselves, are subject to revision by subsequent actions."

Christians are advised in Gospel and epistle to pay their proper taxes to the governing authorities (Matthew 17:24, 22:19, Romans 13:6). Their obedience to God normally includes the obligation to pay their just share of the cost of public order, justice and service which God has appointed the authority of government to provide. Since this advice applied to an imperial Roman regime, how much more apt it is in respect to a government in which the citizens have a voice in the imposition and disposition of their taxes. Although individual Christians for reasons of conscience sometimes refuse to pay a particular tax, in general we recognize and uphold the power of taxation as the necessary mechanism by which the resources of society are directed to the ordering of its life and the solution of its problems.

The New Testament does not deal directly with taxation of Christians in their corporate activities, but its recognition of government's right to tax has implications for the church as a corporate structure in the modern world.

1. Churches should ask of government (for themselves) no more than freedom and equality. For all members of society, Christians expect government to establish and maintain justice, order, defense, welfare and liberty, recognizing that in a democracy they and all others share in the

responsibility which government discharges. They can also ask that the tax laws be administered and enforced fairly, equitable and expeditiously for all. For themseleves and their churches, however, Christians ask no more from government than freedom to proclaim and bear witness to the Gospel: to preach, to teach, to publish, to worship and to serve in obedience to the will of God as it is made known to them. They ask of government protection of this freedom rather than direct support of their activities. Churches can ask exemption from taxation only if it is essential to protect their freedom or to afford equal treatment among them.

2. Tax exemption can be a safeguard of the free exercise of religion In the United States, it has been a basic public policy since the founding of the nation to accord to freedom of religion, speech press and assembly a "preferred position" at the head of the Bill of Rights. Christians support and affirm this healthful arrangement of the civil order, not solely or primarily for themselves and their churches, but for everyone. Citizens, whatever their beliefs, should likewise appreciate the policy of our society that the free exercise of religion cannot be licensed or taxed by government. Property or income of religious bodies that is genuinely necessary (rather than merely advantageous) to the free exercise of religion should likewise not be taxed. Except for cases where exemption is required to afford equality with other eleemosynary institutions, such exemption should be confined to the essential facilities of the church and to the voluntary contributions of the faithful for the operation of the religious organization.

Such exemption has usually been regareded as a benefit but not a subsidy (in the sense of a cash outlay). There is no doubt that an organization is financially stronger with a tax exemption than without it, but the exemption does not convey to the organization funds it has not already attracted from voluntary contributors on its own merits. That is, a church cannot be built with a tax exemption alone. It is built by the donations of its adherents because they believe in its purposes. Exemption from taxation merely permits full use of their gifts for these purposes without drawing off a portion for the purposes of the whole society, which the members already support directly through the taxes they pay as individual citizens.

3. Government may encourage voluntary organizations through tax exemption. Society is stronger and richer for the voluntary associations in which citizens voluntarily band together for constructive purposes independent of government support and therefore of government control. Exemption from taxation is one way in which government can and does foster such voluntary groups.

Christians may agree with other citizens in the civic judgment that it is good public policy not to tax nonprofit voluntary organizations. Though they may view religious organizations (especially their own) as something more than "nonprofit voluntary organizations," they may concede that it is an appropriate category in which government may classify them. If religious organizations are so classified and so exempted, they do not thereby enjoy any "special privilege" that is not shared with a broad range of generally meritorious secular groups.

4. Tax Exemption may entail conditions which Christians cannot accept. Society may extend exemption from taxation to religious organizations on the condition that they meet certain tests, such as subscribing to loyalty oaths or refraining from political activity. Whatever may be the civil merits of this policy, Christians must determine independently whether the acceptance of such conditions will hinder their obedience to the will of God, and, if so, dispute the conditions. If tax exemption will tend to curtail or inhibit their efforts to affect public policy, churches may want to set up non-exempt agencies for political activity, using contributions that are not deductible.

5. Taxation on real property of religious organizations. Depending upon the exigencies of the total tax base, states and municipalities may be more or less generous in exempting the property of religious and other nonprofit voluntary organizations from taxation. Parsonages and parking-lots are taxed in some localities but not in others, at the discretion of the legislature. Religious organizations have accommodated themselves to a wide range of such provisions over the centuries, and will continue to do so. They should not begrudge paying taxes on auxiliary properties to help defray the costs of civil government. Certainly no exemption from property taxes should be sought for property owned by religious organizations which is not used primarily for religious (or other properly exempt) purposes.*

Churches should be willing to pay their just share of the cost of municipal services which they receive, such as fire, police, and sanitation services. Some do this through voluntary payments "in lieu of taxes;" others might offer to pay service-charges for the particular services they use.

6. Deductibility of contributions to religious organizations. At present, citizens may deduct from their taxable income certain gifts and contributions to a wide variety of "charitable" organizations -- religious, scientific, literary, humane, educational, etc. Where it is public policy to encourage contributions to voluntary nonprofit organizations in this way, religious organizations need not be arbitrarily excluded from that classification, nor given preferential treatment. If it becomes public policy not to allow deductibility for contributions, religious organizations should not claim a special privilege of deductibility.**

7. Taxation of employees of religious organizations. Employees or other functionaries of religious organizations -- lay or clergy -- should not enjoy any special privilege in regard to any type of taxation. A clergyman properly pays his income tax just as other citizens do. If he receives a cash allowance for housing, that amount should be taxed as part of his income, as it is for laymen. Likewise, if he owns his own home, he should not enjoy any reduction of property taxes which is not equally available to his unordained neighbor. In case of cash allowance, only the non-recoverable costs, which do not include payments on principal

should be included; if property taxes and interest are included in the allowance, they should not also be claimed as deductions.

Whether the value of housing provided a clergyman by his church should be taxed is a question that should be resolved as part of the broader category of all employees who occupy residences furnished for their employer's conveniences. Equity might be better served if the dollar equivalent of all such housing was taxed as income. In localities where parsonages are exempt from school taxes, provision should be made by local churches for payment of tuition or the equivalent. Whatever the solution, churches should compensate their employees for any losses incurred through the elimination of special privileges from the tax laws. We favor legislation requiring payment by churches and church agencies of the employer's contribution to social security tax for both lay and clerical personnel (except those bound by a vow of poverty).

8. Unrelated business income. Churches constitute one of the few categories of otherwise tax-exempt organizations which do not pay taxes on the income from business enterprises they own which are unrelated to their exempt purpose. Churches should not be in a position where they are tempted to "sell" their exemptions to businesses seeking a tax advantage over taxpaying competitors. Therefore we urge that federal tax law be revised so that any "church or convention or association of churches" which regulary conducts a trade or business that is not substantially related to its exempt function shall pay tax on the income from such unrelated trade or business.***

9. Disclosures. If they engage in unrelated business enterprises, churches should be required to file full financial reports with respect thereto. Even if not so engaged or required, it is good policy for churches voluntarily to make available to the public a complete, audited annual report of income and expenditures, assets and liabilities so that there is no mystery about the nature and extent of their operations.

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* Property obtained for expansion or relocation of churches (and the income derived therefrom, if any) may be exempted for a reasonable period of time until the church can expand or relocate on it.

** An existing statement by the General Board of Feb. 27, 1963, supports the deductibility of charitable contributions and opposes a "threshold" on such deductions.

*** This revision could best be made by deleting from Section 511 of the 1954 Internal Revenue Code the parenthetical expression: "(other than a church, a convention or association of churches)," and making suitable provision as to "business lease" rental income which is debt-financed.

Those changes would not affect dividends, interest, annuities, royalties, capital gains, or rents from real property (except as already indicated).

We would not object to a delay of up to five years in applying such taxes to businesses now held by churches, nor to a "floor" deduction large enough to permit trivial or transitory activities by churches which do not rise to the level of serious competition with taxpaying trade or business.

The definitions and descriptions of "trade or business" "regularly" "conducts," and "substantially related" in Treasury Regulations, Paragraph 3256, seem generally reasonable and equitable, and do not appear to threaten the legitmate exercise of religious freedom if applied to churches.

Federal Investigative Agencies and the Churches

Background Statement

As a result of a lawsuit instituted under the Freedom of Information Act by the Center for the Study of Responsive Law, documentation was obtained from the Internal Revenue Service showing the creation within that service of an "Activist Organizations Committee" in 1969. Later known as "Special Services Staff," it was designed to cooperate with other executive agencies and with legislative committees in collecting "relevant information" on organizations deemed to be "dissident or extremist," "militant," "revolutionary" or "subversive."

Copies of this documentation have been obtained from the Center for the Study of Responsive Law by the General Counsel of the National Council of Churches. On one list of "Ideological Organizations Under Examination or Recently Examined (dated July 1, 1969) the name "National Council of Churches of Christ, New York, New York" appears. Also on that list is the "Interreligious Foundation for Community Organization" (IFCO), a sub-tenant of the NCC organized by several of its member denominations, and recently authorized by the Governing Board to become a sponsored related movement of the Division of Church and Society.

Later in 1969, both NCC and IFCO were notified by IRS that they were to be audited for the years 1968 and 1969. Those audits began early in 1970 and ran through April, 1972. At that time both organizations were notified that they continued to be exempt though both were "inadvertently" omitted from the 1972 and 1974 IRS listings of exempt organizations for which deductions can be claimed on federal income tax returns.

In addition, IRS also audited the personal income-tax returns of IFCO directors and staff. The exemption for cash housing allowance paid to the Baptist clergyman serving as its director was disallowed as "not being in furtherance of his religious ministry," though he was commissioned to it as an "ecumenical missionary" by the American Baptist Home Mission Society, which is contesting his case in court.

STATEMENT OF ARTHUR C. BORDEN, DIRECTOR, EVANGELICAL COUNCIL FOR FINANCIAL ACCOUNTABILITY, WASHINGTON, D.C.

Senator GRASSLEY. Mr. Borden.

Mr. BORDEN. Mr. Chairman, I'm very glad to be here today. Let me just take a few moments to highlight a few of the things which are of concern to the Evangelical Council for Financial Accountability.

We are foremost concerned with accountability, about the proper conduct, procedures, standards, and integrity of our member organizations. That's why we exist. We try to verify that each member of ECFA is a legitimate 501(c)(3) Christian organization. Many of them are churches; not all of them are churches.

In fact, it's our assumption, based on very good information, that the great majority of churches in the United States cannot even comply with our standards. And, therefore, would not qualify for memberships. So I think that our standards and our concern for the integrity of organizations go far beyond the mere requirements of the IRS.

We are grateful for this bill so that those organizations which do come under the scrutiny of the IRS will know the procedures. I think this is very significant that the organizations do know the procedures and know how to deal with the IRS when there is a desire or a felt need to make an audit.

This bill is significant in the fact that it does not protect wrongdoing. It does not try to cover up any fraud. It does not try to cover up even ignorance of the law, and some churches are ignorant of the law, and, therefore, do not comply.

It also, I think, is very important in that it recognizes the distinct place of the church in our system and our society. And it deals very well with that fine line of separation in recognizing that crime and fraud and unlawful acts should be prosecuted; that individuals or groups should not be able to hide behind the facade of a church. Yet it does recognize that distinction so that those which are churches and which do have this special protection, as defined in the Constitution of the United States, are protected.

We feel that guidelines would be beneficial to the churches in that they would know what to expect, and also be beneficial to the IRS. It would save time, money and effort from the employees of the IRS in not having to investigate those organizations which are obviously churches.

There is another interesting aspect concerning churches. It is very easy to recognize most of the groups that call themselves churches in this land of ours without any difficulty. These groups have a scrutiny which few other organizations have. Therefore, there is probably less likelihood of having wrongful use of funds or transgressions of the law occur. They, of course, are scrutinized by their membership. Many of the members attend the services weekly and are very much involved and concerned. Then those churches which are members of a denominational structure are scrutinized from above, as well, so that there is that dual scrutiny within the organization.

We trust that the Senate and Congress, in their wisdom will see fit to pass this bill so that guidelines will be set down and that we will know definitely the rules under which we are operating. From these wrongful acts can be identified. But that legitimate churches can be protected and have the due recourse of law that other groups and other organizations have in other parts of our society.

Senator GRASSLEY. Thank you.

[The prepared statement of Arthur C. Borden follows:]

Testimony Before the
Subcommittee on Oversight of the
Internal Revenue Service

by

Arthur C. Borden
Executive Director
Evangelical Council for Financial Accountability
September 30, 1983

Mr. Chairman.

Thank you for the opportunity to appear before this subcommittee and present testimony to support Senate bill S.1262, the "Church Audit Procedures Act of 1983."

The Evangelical Council for Financial Accountability (ECFA) is very interested in this bill. We represent 245 organizations whose membership includes local churches, church organizations, denominations, and denominational agencies.

These organizations have joined ECFA because they are committed to maintain and uphold the highest ethical and financial standards and practices. Membership in ECFA requires all organizations to practice full financial disclosure through the publication of annual audited financial statements. These organizations are required to have a responsible governing board, maintain the highest standards of integrity and avoid conflicts of interest. Appeals for donations must be clearly defined as to their purpose and program. Donations must be channeled to their intended project.

Mr. Chairman, ECFA and its members are not only concerned that all churches be bona fide churches, but that their activities are in obedience with the law. They must follow the highest standards of Christian stewardship in their financial practices.

The fact that the overwhelming majority of churches are bona fide does not preclude that groups have sprung up using the term "church" as a means to avoid the payment of taxes.

It is also a well known fact that churches frequently are not acquainted with the law. And there are even churches that think that anything involving God is above the law.

We must then recognize that the government has a legitimate reason to have means of identifying what is a church and what is not, as well as the means to hold accountable those groups that do not qualify as a church.

A problem arises when the Internal Revenue Service or any other governmental agency goes to excesses to try to do its proper job. Unfortunately, the IRS has gone to extremes in a number of cases, as indicated in the case of the Miletus Church in Texas and the Church of Christian Liberty in Brookville, Wisconsin.

In the same way that churches must be accountable for their actions, so must the IRS be held accountable. This bill, in my opinion, does that in a reasonable and rational way.

This Church Audit Procedures Act is importart to both churches and the Internal Revenue Service. It is important to churches because they need to know the rules concerning investigations. As it is now, the rules are either not established or published. This bill will remedy that situation. The rules also need to be clear enough to understand and follow so that pastors and church leaders, who are not attorneys, can understand them.

They must also be promulgated so that there is ample opportunity to contest them if necessary.

The authority of any agency of the government relating to churches must be established in such a way as to recognize the unique relationship and distinction that we have in this country as it pertains to Article I of the Constitution. This delicate relationship between church and state must not be abridged by the regulations of any agency. Whenever there is a danger of this relationship being compromised, Congress has a duty to intervene. There must be assurance that the Constitution be scrupulously adhered to.

Mr. Chairman. I am glad to say that this bill does that. You are to be commended for introducing this legislation.

The IRS should also look on the proposed legislation as more of a help than a hinderance. By following the requirements of this act the IRS will save itself countless hours of fruitless investigation into the matters of legitimate churches, to say nothing of the dollars it might save.

These unwarranted investigations also deplete the resources and energies of legitimate churches and their members. Some of the small churches that have been investigated have not only run up large expenses for legal defense, but have been completely distracted from their appropriate and legitimate ministries -- proclaiming the Gospel of Jesus Christ. Their leadership is overwhelmed with the need to establish what is obvious, in order to remain a church. It is an anomaly that, as a result of an IRS investigation, a church must forfeit the opportunity to do its churchly duties in order to prove that it is a church.

Permit me to suggest that there is probably less of a need for the IRS or any other governmental agency to investigate a church than most segments of our society. Churches are open to scrutiny few other organizations in our society have to withstand. The membership of most churches has a far greater interest in the operation of their church than the members of other organizations. They are involved on a weekly basis and are usually intimately aware of the activities of not only the leadership, but of other members. The members of a church are able to vote with their pocketbooks. These are strong factors that make churches accountable in ways in which few other organizations are accountable.

In addition to this accountablilty from below, most of the churches in this country are part of some denominational structure. This leads to an accountability from above. You have people watching over the shoulder of the leaders of the local church from both directions. Churches are scrutinized as are few other organizations.

It is also important to recognize that most of the cases of abuse, in using the cover of a church to defraud the government, have been so obvious and blatent that there is little trouble in identifying them. There are over 300,000 churches in this country and the problems for the government are few and far between. Reasonable restraint rather than reckless unguided investigatory procedures is the sensible solution.

Let us take a minute and look at some of the specifics of this Church Audit Procedures Act.

Specifying in detail the legal and/or factual points of concern and why an examination is necessary; providing time for a conference in which the church could respond to questions prior to the IRS's decision to investigate and audit; and giving advance notice of the commencement of the investigation and subsequent audit are all standard due process procedures. These simple procedures will not only save the churches involved many headaches and problems, but will conserve the resources of the IRS. The IRS will only have to deal with verified complaints.

The establishment of a three-year statute of limitations on the assessment of taxes is just a matter of fairness.

A limitation on the length of time between the beginning and the ending of any investigation is also a reasonable request.

To allow a church to enjoin the IRS from proceding with an investigation under certain conditions is also a reasonable and hollowed right in our legal system.

A mandate that a church may be considered to have exhausted all administrative remedies, upon notification of the revocation or suspension of its tax-exempt status allowing it to go to a court of law to challenge such a decision is also reasonable.

The inclusion of churches in the section of the IRS Code allowing for the recovery of attorney fees, should the church be proven innocent would enable the church to redirect those funds misspent in an investigation and use them for the purpose for which the church was established.

Mr. Chairman, this bill which you have introduced, is trying to redress a wrong; to assure that the IRS acts in accordance with the Constitution; and to introduce fairness into the procedures of this important government agency. We all agree that there needs to be a way to correct abuses, prohibit fraud, and stop illegal activities. This bill does not interfere with the IRS in carrying out its legally assigned responsibilities as an agency of the United States Government. I hope that this committee will send this bill to the Senate and that the Congress of the United States will approve it and that the President will sign it into law to guard against any encroachment on the rights churches have as protected under the Constitution of this great land of ours.

Again, I commend you for taking the leadership in this matter to preserve the delicate balance between church and state. Thank you for giving me the opportunity to testify today.

STATEMENT OF JEREMIAH S. GUTMAN, LEVY, GUTMAN, GOLDBERG, & KAPLAN, NEW YORK, N.Y.

Senator **Grassley**. Mr. Gutman.

Mr. **Gutman**. Thank you, Senator.

As a litigator, I'm delighted to have the last word to the jury this afternoon, and I intend to take advantage of that stroke of fate.

I have been accused of being a zealot, a religious zealot, and I will confess to a zeal, perhaps a religious zeal, if you will, for the first amendment. That has been my life, and it continues to be my life.

I believe that the first amendment and its first clauses, the religion clauses, the antiestablishment clause, and the freedom of exercise clause, had a primacy not only because of their position in the accidental listing of the amendments, but in the philosophy of our government and that the Church Audit Procedures Act is well designed to protect against establishment and to foster freedom of exercise of religion.

As those who are concerned with the precise use of language, I think we should note that, during the course of today, the Secretary and the Commissioner, and several of the witnesses, have referred as though it were a pejorative to protesters—and I protest. Protesters are protected by the first amendment. The first amendment guarantees the right to speak out in protest, the right to petition for a redress of grievance, the right to free speech and press, in addition to the religious laws. So that while it is true that there are those who would abuse the shield of the first amendment for gain or other fraudulent purposes—there are people who commit murders and others who commit other crimes—and they ought to be prosecuted for it, I think the first thing we ought to do—and perhaps the Church Audit Procedures Act is a step in that direction—to educate the Commissioner of Internal Revenue and the Secretary of the Treasury. But protesters is not the word to attach to tax evaders, those who commit fraud. The protesters are protected; those who commit criminal tax evasion are not and they ought to be distinguished.

Mr. Lehrfeld suggested that there is something in this proposed legislation which would make a religious entity something more than the sum of its members. That isn't from the Church Audit Procedures Act. That's from the Constitution of the United States.

Indeed, a religious assembly is more than an assembly of individuals. It has a special status, qua-church, because the Founding Fathers decided that of all those entities which were to be recognized and protected—the one that was to have preferred status—the highest protection was the church. People who come together for the purpose of exercising their religion.

Several of the witnesses—Secretary, Commissioner, Mr. Lehrfeld—had suggested that, because the regulations give or purport to give a certain amount of protection, what we ought to be doing is merely to explore what abuses there are, how the regulations can be perfected within the agency, and then we can cure the evils or the imperfections.

I suggest that the Church Audit Procedures Act is necessary because what Caesar in his regulations can give, Caesar in his regulations can take away. And it is up to Congress to set the perimeters within which the regulations may be promulgated.

Because a church is more than the sum of its members, a church is not merely a statistical taxpayer who can be selected at random, as I might be or you might be, for audit. A church cannot be subjected to the same standards as other taxpayers because the church has that special, special status guaranteed and created by the first amendment. "Create" is the wrong word. I think that status predated the first amendment. The first amendment recognized it, enshrined it and guaranteed it. The status existed before because it is one of the basic human rights which preexisted our own Constitution.

Senator GRASSLEY. Did you have a thought or two, if any?

Mr. GUTMAN. I have made notes of the specific areas of objection to the bill. There has been talk about a possibility of dialog in an effort to perfect. I have very strong feelings about the right of the Treasury and the Internal Revenue Service to look at third party records. Under what circumstances, whether there should be a warrant, what should be the standard for the warrant, whether the fourth amendment applies, whether and when the word "evidence" was to be used as a threshold. Perhaps the words "probable cause." They are in the fourth amendment. Nice words. They have lasted a couple of hundred years and done very well for us. Maybe probable cause is the standard we should use. Perhaps those who will take a different view of the bill and the thrust of it might say that I'm making the burden higher. Perhaps I am doing so or propose to, but I don't deny that.

I think the burden should be higher because, before the Government enters the church, there is a high threshold over which it must step. And there should be at least probable cause before it gets into those church records.

If there is to be a third party record examination, the church should be provided with notice that the effort is to be made so that the church, if it wants to, thinks it's appropriate, can seek a judicial quashing of the subpena or other process which is at issue unless the Commissioner can meet some high burden to establish to a court to get it to issue a noticeless warrant. Such as, for instance, analogously to the wire tap, a nonnotice wire tap. But you would have to have a big showing. I think that should be addressed in the bill.

On the 365-day limit, there is already in the Internal Revenue Code a provision, a blanket provision, which I believe already would cover churches, an extension by taxpayer agreement in order to prevent the necessity for a jeopardy assessment. If I'm wrong, and the statute needs to be amended, so be it. But we don't have to extend the 365-day limit because there is no need for a jeopardy assessment because there is the waiver provision by which the taxpayer can voluntarily extend it should it seem in the advantage of the both parties.

The 3-year statute, I think, is essential in the absence of fraud. But the burden must be on the Government. There is a different statute of limitations in the ordinary taxpayer between a fraudulent return and an ordinary return. I think that same standard could be applied here. Three years and the absence of fraud, I think is superb in the act as it is drafted. A longer statute in the case of fraud. Certainly no less than the nonreligious taxpayer gets. I think it would be unconstitutional to give less. It would be appropriate to give a shorter period of time.

I have lots of more details which I would love to address, and if you will bear with me—let me just say a word about the injunction. It's been suggested that the injunction procedure would delay determination. Quite to the contrary. It would eliminate the exhausting procedure, the exhaustive procedure which now is required so that the church could proceed to enjoin the assessment, to enjoin the revocation of status, to enjoin the ongoing audit, if that audit failed to comply with the procedural rules which the Church Audit Procedures Act involves. I think the injunctive procedure is essential if the CAP is to be anything.

If it is merely to be that 6 years down the road you can get the Supreme Court of the United States to deny a writ of certiorari on your successful appeal to a Circuit Court that the assessment was wrong because they didn't follow the procedure, and you have gone broke proving it, that would be a destruction of religion. The church ought to be able to go immediately to enjoin the ongoing assessment procedure if it is, indeed, in violation of the statutory standards which I hope the Congress is going to enact.

I thank you for the tolerance of my extended remarks.

Senator GRASSLEY. Yes.

[The prepared statement of Jeremiah S. Gutman follows:]

Testimony of Jeremiah S. Gutman

My name is Jeremiah S. Gutman, and I am an attorney who has been practicing in the fields of civil liberties and civil rights for more than three decades. I appear today on behalf of religious liberty of all groups and individuals, but particularly to express my concern on behalf of those churches and religious groups who are out of the mainstream of religions well established in American tradition. The International Coalition Against Racial and Religious Intolerance, to which I am counsel, is an organization of religionists, theologians, lawyers, and friends of religious freedom with members throughout the world. It has asked me to present its point of view today. The Holy Spirit Association for the Unification of World Christianity [more popularly known as the Unification Church], The Way International, the Church of Scientology, and other churches and church groups have been kind enough to make available to me their opinions and data, which are included within these remarks.

The newer and smaller churches of America welcome the prospect of the passage of the Church Audit Procedures Act.

I present as an example of the kind of abuse which arises from the same defects in existing law, and absence of proper church audit procedures, which require the enactment of the Church Audit Procedures Act a criminal case which attracted, justifiably, a great deal of attention in the community of religions.

Recently, the Internal Revenue Service, at a cost to the taxpayers which has not been disclosed, secured a conviction, presently under appeal, of the Reverend Sun Myung Moon for alleged income tax offenses. It is undisputed that the Internal Revenue Service had been urged by one or more members of Congress, who in turn had been urged by numerous constituents to "do something" because of the perceived dramatic increase in attractiveness of the doctrines of the Unification Church to growing numbers of Americans, particularly young adults. A dissenting opinion by Second Circuit Judge Oakes would have held that the Reverend Moon was improperly convicted because the Internal Revenue Service, the trial court, and his colleagues on the Second Circuit failed to reognize that "[t]he religious context involved gives the case a special color." Additionally, Reverend Moon had argued in that case, and will again present that argument to the Supreme Court of the United States no doubt, that he had been deprived of the fair and impartial trial to which he was entitled when the United States chose to retaliate by imposing an unwanted jury, which Reverend Moon had a right to waive, because Reverend Moon had announced after his indictment that he had been selected for prosecution, singled out from other members of the clergy identically situated, because his skin is yellow and because his religion is Unificationism rather than that of a church on a typical Main Street, U.S.A. It is the perception -- and in the case of Reverend Moon the actuality -- of such inequality of treatment, prejudice, and destructive differentiation among favored and unfavored religious groups which requires that the Church Audit Procedures Act become the law of the land. True, it does not address, nor is it intended to address, the selective prosecution and unconstitutional motivation of the Government in punishing an exercise of free speech by Reverend Moon, but the issues out of which such unconstitutional results arise are the same as the evils against which the Church Audit Procedures Act is directed. Reverend Moon puts his faith in the Supreme Court of the United States to rectify the errors of fact, law, and constitutional interpretation which the courts below have made in his case, but the small, the multitudinous, and threatened religious bodies of this country appeal now and must look to the Congress of the United States for their protection against the evils and threats which the Church Audit Procedures Act is designed to eradicate.

In its Examination Procedures [7(10)00], the Internal Revenue Service describes and sets vague guidelines for its Illegal Tax Protestor Program. Examination of these Procedures, as they have existed from time to time with such amendments as there have been, and a look at the Internal Revenue Service's Ideological Orgainzations Project can do nothing but cause fright to a civil libertarian. The very idea that the tax collector -- or, indeed, any agency of the Government of the United States -- would devote special attention to organizations because they are "ideological" or to those who specially protest against the activities of the investigator should raise the hackles of a defender of the First Amendment. If a protest is illegal, it is not then a protest. The act of protestation is one of those which is embraced within not only the free speech, press, and assembly clauses of the First Amendment but within its right to petition for redress of grievances. If the protest is accompanied by some illegality, it is for the police to enforce the criminal law. If it is accompanied by a refusal to perform a duty imposed by law, for example, to execute and file a tax return, the penalty therefor should be enforced by law. It is not the protest, the protestation, or the protestor who should draw the fire and ire of the Internal Revenue agent. The Examination Procedures are specifically aimed at the wrong target and in violation of the Constitution. It is up to Congress, by enactment of the Church Audit Procedures Act to bring the Internal Revenue Service back into line.

The Church Audit Procedures Act is required in order to remove a continuing and persistent threat to free exercise of religion and to prevent other violations of the Religion Clauses of the First Amendment to the United States Constitution.

Because the constitutionally mandated limits upon the subtantive intrusion and procedural entanglements [Lemon v. Kurtzman, 403 U.S. 602 (1971)] inherent in an audit of a church are not articulated in any Congressional enactment, and because such legislation as exists is obviously, and has been judicially declared to be ambiguous at best [United States v. Coates, 692 F.2d 629 (9th Cir. 1982)], continuation of the present silent, brooding potential of a swooping down upon a church by the Internal Revenue Service presents a constant threat to free exercise rights. It is the duty of Congress to act.

It is true that the Internal Revenue Service has issued procedural guides to its personnel, but it is also true that such guides have been revised and remain subject not only to further Internal Revenue Service revision but to revocation. It is also true that the experience of less affluent and less popular minority religions has demonstrated the need for unambiguous restraints and limitations against potential abuses, and assurances to religious organizations and personnel, as well as to Internal Revenue Service personnel, of what can be done, and when, and for how long, and under what circumstances.

At least one President of the United States created his enemies' list and abused his powers, among other ways, by unleashing agencies, including the Internal Revenue Service, against them. The history of religious multiplicity in the United States teaches us that new religions arise with more or less vigor, but with consistency, from the fertile soil of our freedom and diversity. History also teaches us, however, that such religious groups in their infancy and youth are often the targets of irrational prejudice and organized assault and that Government agencies, certainly not excluding the tax collector, are urged by opponents of one or more of the new religions to do something, to take action, to preserve the establishment, to eliminate what may genuinely be perceived as heresey but which must be constitutionally recognized as religious heterogeneity.

The Internal Revenue Service Commissioner and her or his subordinates who wish to act constitutionally should be able to point to a clear Congressional enactment which prohibits them from becoming entangled in the affairs of a church which may have found disfavor with a President, a member of Congress, or a group of vocal constituents. The Church Audit Procedures Act can provide such a shield against invitations to unconstitutional action.

Religion is in a special category in our American scheme of things by the very first clause of the very first provision of our Bill of Rights. Religious bodies and the religious freedom of each individual are specially separated from government activity, whether of support or attack, and from governmental intrusion and entanglement. Of course, every citizen and resident has an obligation to all the rest of us to participate, according to the rules, in sharing the burden of governmental costs, an inevitable consequence of the omnipresent possibility of inquiry by the tax collector. Churches, however, because they are churches and because they have been differentiated by the Founding Fathers from all other types of organizations, have a very special protected status and should not be subject to that same potential for inquiry and intrusion which may appropriately be cast as a shadow over different organizations and individuals. To make this statement is not to say that the self-proclaimed church should be able totally to insulate itself, but that the status of churchhood, in conjunction with the First Amendment, places upon the Government a special burden to establish not only the justification for but the extent of, the timing of, and the duration of inquiry. The Church Audit Procedures Act is well designed to accomplish that result, to provide appropriate mandates and legislatively defined protections without threatening the revenue or providing a shield for the disingenuous, the charlatan, or the criminal.

Experience should teach us that it is precisely the small, the unfamiliar, the novel, the exotic group which is most likely to be the victim of the tax collector's harassment. It is The Way International, the Unification Church, the Lord's Covenant Church of Scottsdale, the World Wide Church of God, the Church of Scientology, the First Church of God the Father which finds itself bearing the burden of professional fees, distraction from religious affairs of clerical personnel, and, too frequently, surrender and payment of tax which may not be justly due but is too costly to defend against. The horror stories of churches which others will undoubtedly be putting before this Committee are with respect to such relatively small, relatively new, relatively bizarre, in light of mainline tradition, churches; rarely is the threat and even more rarely is the actual intrusion and entanglement suffered by the older, the more well recognized, the better "established" religious bodies. Because the burden falls in such a way, the result has been, in absence of a Church Audit Procedures Act, an unconstitutional promotion of establishment of religion, discrimination against the small or independent in violation, not only of the admonition of the First Amendment prohibiting the establishment of religion -- that is, the preference of one or some over others -- but in violation of due process and equal protection clauses and concepts of our Constitution.

It is the thrust, and it will be the effect, of the Church Audit Procedures Act to provide a shield for free exercise of religion, a bulwark against a trend toward establishment of religion, and a standard of due process and equal protection, which experience has shown are all vitally needed if the promises of the First Amendment are to be kept.

Senator **Grassley**. Do any of you demand equal time? [Laughter.] I'll start with Mr. Lehrfeld. And I suppose I ought to invite any of you who want to speak to any of the points of any of the other people to feel free to so do.

As a matter of clarification, you aren't saying that there might not be some legitimate changes in the way IRS relates to churches, but you are saying those should not be addressed by legislation. If they need be, to be addressed by regulation.

Mr. **Lehrfeld**. Precisely, Mr. Chairman.

Senator **Grassley**. But you aren't denying that there might be some changes in regulations that need to be done?

Mr. **Lehrfeld**. Oh, no.

Senator **Grassley**. All right.

Mr. **Lehrfeld**. I mean I think throughout this there are several good ideas in the proposed legislation. But I think that audit procedures as such must be sufficiently flexible so that when there are aberrations the procedures can be immediately changed. You know full well as a member of the committee how long it takes to draft and then polish tax legislation, get the agreement of the other body, work out a compromise that's acceptable, and then forward it to the President for signature. If you have a process under the existing regulations, the procedural regulations, whereby the Service provides the kinds of announcements, if you will, and explanations of the purpose of the audit and what records they will expect, I think that would not only help churches; it would help all exempt organizations. And probably for that matter, all taxpayers.

Senator **Grassley**. You obviously perceive problems in further distinguishing churches from other taxpayers in the process of administering tax laws. What problems?

Mr. **Lehrfeld**. Well, let me give you an example. And this is an internal document that was released. A GCM, which is General Counsel, memorandum, 38982, on the issue of whether or not a radio ministry is a "church." This IRS opinion concludes that such a ministry is not a church by applicable internal standards. Therefore, if the Internal Revenue Service concluded that the XYZ radio ministry should be examined, and the ministry claims it is a church, and it argues the IRS must go through the section 7605(c) procedures, as amended, you are going to get delay of the IRS audit because someone has to decide whether or not a radio ministry is a church and entitled to these new protections.

All we have right now is law by press release. If you wish, we can enter this in the record. The press release is IR-1930, remarks by Jerome Kurtz in 1978, Difficult Definitional Problems in Tax Administration, Religion and Race. This is the basic document at the present time that tells an Internal Revenue examiner what is a church. And we know that the word "church" appears 17 different places in the Internal Revenue Code, and yet nowhere is it defined.

The word "religious purpose," which appeared in the Internal Revenue Code's predecessor, the Payne-Aldrige Tariff Act of 1909, has been there for 70 years and no one has told us what "religious" is by the regulatory process.

So if this bill can act as an incentive to the Revenue Service to go through the administrative process for regulation, to define religious purpose, and define what is church, we may come to a better understanding of whether or not a radio ministry or anything that does not look like a church—anything that doesn't have a steeple—is, in fact, a church in law. By doing so, you help guarantee some of the protections which other panel members believe should exist.

Senator GRASSLEY. You addressed this next question just a little bit, but I would like to hear you address it from the perspective of clients you had and cases you have had.

Has the IRS significantly abused the audit procedure to justify some of the proposed changes in the law?

Mr. LEHRFELD. No. I can't think of a single instance in 23 years where that has occurred; and that is both as a member of the Internal Revenue Service for 6 years and in private practice for 18 years.

Senator GRASSLEY. Mr. Kelley, do many of your member churches undergo audits?

By the way, let me say that we will insert in the record—and let me say this to Mr. Lehrfeld because I don't want to leave the impression that we are proceeding with legislation on the basis of Mobile, Ala. church. We will put in the record many other examples.

Could you answer the question of how many of your members might have undergone audits?

Reverend KELLEY. There is no way of knowing that, Senator, for one good reason. People who undergo audits from the Internal Revenue Service, particularly churches, are about as willing to talk about it or report it as people used to be to admit that they had a maiden aunt in the lunatic asylum.

Senator GRASSLEY. All right.

Mr. GUTMAN. Could I respond to that briefly, Senator?

Senator GRASSLEY. Yes.

Mr. GUTMAN. You mentioned at the outset that I represent some of the more unpopular religious groups. Among the groups which I have represented in various connections is the Unification Church, sometimes known as the "Moonies." They in their national headquarters building have a room with a special desk, and that belongs to the Internal Revenue man. And they set aside a separate room there for him. He is there so much.

The Church of Scientology, which I have represented in some other things but never in connection with this item—they have been engaged with the Internal Revenue Service over a period of years.

The Scientology file with the Internal Revenue Service is several feet long. Stacks and stacks of papers that extend over years. I'm sure that a member of that church would be happy to come in and tell you of his experiences.

Senator GRASSLEY. Do you, Mr. Kelley, see this legislation as making the audit process less adversarial? And remember that Treasury feared that it might make it a little more adversarial.

Reverend KELLEY. I think that's a variable. It would probably depend upon the organization and the particular agents involved. We had an agent in our audit who was very zealous to find evidence to justify withdrawing the exemption of the National Council for what he considered political activity and opposition to the Vietnam war. He had to be repeatedly calmed down by his superiors. But it might have been the other way around.

If the act would manage to regularize that so it would not be a matter of individual impulse and disposition, I think that would be a great advantage over the present situation.

Senator GRASSLEY. Mr. Borden, your reputation is one of successfully resolving conflicts for your member churches with the IRS. Has the IRS been cooperative in working to resolve disputes?

Mr. BORDEN. We have found that on the highest levels here in Washington the IRS has been cooperative and supportive of what we are trying to do. I think that they feel that we are trying to make their job easier by setting up certain standards and encouraging organizations to maintain those standards. There has been a positive reaction, unofficial reaction, but that positive reaction from the IRS toward ECFA concerning our purposes and our reason for existence.

Senator GRASSLEY. Can I ask you as a follow-on, before you finish, have they worked with you to devise better methods of auditing and procedures?

Mr. BORDEN. No, we have not had any formal relationships or formal contacts along those lines.

Senator GRASSLEY. Did you finish your answer to my first question? I interrupted you.

Mr. BORDEN. That's fine. I was just indicating that a number of our members, because of their prominence, have audits, and have had the IRS come in. When there are problems, that is when ECFA is interested, because we are interested in compliance with our standards, which I feel that in many cases are more strict, particularly in the handling of finances and the administration of finances, and the uses to which those moneys are applied.

We actually have one of our members now, which the IRS has said they are going to audit. They've indicated to us that they intend to cooperate with the audit. In fact, I will be meeting with them face to face in a couple of weeks with another member of our standards committee, and find out what the status of that is.

We want our members to more than comply with the law. And when they are not in compliance then we question where they are and what those concerns are to see how they affect our standards.

Senator GRASSLEY. From your members, can you tell us the most frequent complaint about the IRS when they are faced with any audit? Any of your members being faced with an audit.

Mr. BORDEN. I think the complaint would be to the extent to what seems to be superfluous detail and information which they request. And then, also, there is the problem of requesting information concerning specific donors and the names, which many of the churches generally consider confidential information. That's a problem between the IRS and the donor, rather than a problem between the organization and the IRS.

Senator GRASSLEY. From that standpoint then, superfluous information requested, does this legislation address that problem?

Mr. BORDEN. It would help in that when there is an audit for some reason, they would have to specify what those reasons are. And that should then limit the general information which can be requested.

Senator **Grassley**. Do you feel that the IRS could correct the defects that bring about the problems that your organization is concerned with administratively or do you think legislation is necessary? And I know you said you support the legislation.

Mr. **Borden**. Well, this is subjective but I would suspect that that depends a great deal on the local agent doing the investigation, and the commissioner in the particular area. And their attitudes or their previous experience, and whether they could be corrected or not. Obviously, some would be more understanding. They would have different attitudes concerning their background and their own particular convictions and relationship with these types of organizations.

Senator **Grassley**. I think I ought to follow up and say my use of the word "administratively"—let's apply that to changing regulations as opposed to passing the legislation, as per Mr. Lehrfeld, who feels that some problems exist and that they ought to be changed by regulation as opposed to legislation.

Mr. **Borden**. Well, I have gone over this particular bill and there are things that I have put in our testimony, with an attorney who is on our board of directors, and who deals extensively in his law firm with nonprofit organizations. In our conversation, he felt that these were reasonable concerns and reasonable requests which are being put forth in this legislation, and that they would be helpful on the basis of his experience. And, therefore, that this is needed, and is desirable.

Senator **Grassley**. Mr. Gutman, do you see an increase in IRS actions against churches?

Mr. **Gutman**. I don't know that I can readily answer that. I can only speak from my experience. Thirty years ago, thirty-five years ago when I went into practice, I wasn't representing churches. In the last decade or so, I have been representing a lot of the less than popular churches out of the mainstream. They certainly feel that they are receiving more attention than they did. I think that that is probably a product of media hype and hysteria.

There has been a confusion in the minds of the press and the public, and some unfortunate expansion to members of the Government and my profession, as to some fancied distinction between a cult and a legitimate—and that word has been used here several times today—religion or religions of legitimacy under the first amendment. It would be an unconstitutional establishment to decide which are legitimate religions.

A cult, as has been said, by Leo Pfeffer is a religion that somebody I don't like belongs to. And I think that there has, because of this confusion of "religions are OK and cults are not," and "all cults are the same," there has been a fallout in the Internal Revenue Service of "let's go after the cults."

And I think there has been a lot of pressure from constituents and Members of Congress who have passed along their concerns to the Internal Revenue Service. And that has resulted in undue, unwarranted, and I feel unconstitutional attention by the Internal Revenue Service to the out-of-mainstream religions.

And exactly the opposite is the opinion Mr. Lehrfeld was expressing. It seems to me that the Church Audit Procedures Act is something that the out-of-mainstream religions need and want because it is upon them that the burden has fallen disproportionately both in terms of the number of visitations and the cost. If a small church has to pick up a legal bill for $100,000, it may well kill that church, in violation of the first amendment. Whereas if one of the mainstream churches or, if Reverend Kelley will excuse me, his organization representing 40 million congregants, has to pick up a bill for $100,000—unfortunate as that is—unconstitutional as that may be, it has a disproportionate impact when a one-branch church or a two-branch church has to pick up a similar item.

Senator GRASSLEY. I like your view on the dividing line between protecting people's right to religious activity and what the IRS can do to stop tax shelters or their efforts to stop tax shelters and tax avoidance.

Mr. GUTMAN. Tax avoidance or refuge I prefer. Tax shelter is perfectly legitimate in many cases.

Senator GRASSLEY. Yes.

Mr. GUTMAN. We are talking about sham or fraudulent use of a facade of religiosity to achieve tax evasion. Well, the courts have been faced for years with the question of what shall be recognized for various purposes as religion. And the best line of cases on this, I think—and the source of the analogies—is the line of cases coming out of the Selective Service law—conscientious objection. The Supreme Court of the United States, I guess in the early 1960's, decided *United States* v. *Seegar* in which, when read in conjunction with the later case of the *United States* v. *Welch* leads to the proposition that if the congregant, in this case the conscientious objector, claiming religious status for the purpose of exemption—if the congregant honestly, not fraudulently, believes that it is a religion then we recognize it as a religion for his purpose. We look at the mind of the person who asserts it. Is that person telling the truth or is that person lying?

The courts and administrative bodies are often faced with that proposition. Is this person telling the truth? When this person says I hear a voice and the voice tells me, Don't go to war," is that person a coward who is hiding behing a sham or is that person a religious individual who is telling the truth?

Juries, judges, administrative judges, and administrative bodies make that kind of determination all the time, and I think that is as far as we can go in deciding whether or not what purports to be a facade of religiosity can have that effect not only for military service purposes but for tax purposes. If it is a legitimate claim honesty put forward, no matter how bizarre—obviously, *Lemon* and *Kurtzman* and *Ballard* and those cases—we can't go into the line of whether anyone in his right mind would believe it. The question is: Does that person, whether in his or her right mind or not, actually believe it? And if the answer to that is affirmative, then it is a religion. And the consequences, whether it's a military service or a tax consequence, follow.

Senator GRASSLEY. You wanted to add to that.

Reverend KELLEY. I sure did. I think that might suffice for a legal determination of an individual's religious adherence or commitment. I'm not sure that it suffices for the purposes of identifying a church sufficient to justify the protections of the Internal Revenue Code and other laws provided for churches.

Bill Lehrfeld made the point that there is no definition of "church" in American law, at least pertaining to the regulations interpreting the code. I think that's very fortunate. And if the Government were attempting to arrive at such a definition, my organization and others like it would protest vehemently because that would tend to freeze the future development of religion to what it is at present or has been in the past.

However, I think there must be ways in which the Internal Revenue Service can differentiate between authentic, legitimate religious enterprises and those which are not. I don't think it is sufficient that an individual or a group of individuals can be self-defining and unilaterally assert that we are entitled to the protections provided for a church. I think, because it is a category of the civil law, that the civil magistrate at some point must assess the validity of that claim. On what grounds shall that assessment be made? Can the magistrate take some preformed definition? I think not. Should the magistrate consult existing religious groups for their opinions? I think not because they are the most immediate rivals to new forms of religion as they appear.

I think the process that should be followed is that if a group asserts a prima facie claim to be a church then the Government—the burden of proof shifts to the Government to demonstrate that it is not. What is prima facie evidence in this instance? I think what it would have to be is some visible resemblance to what is acknowledged religious behavior in society today, a rebuttable presumption. And it would be typified by the 13 or 14 points the IRS uses as identifying points of a recognized religious body.

As I say, that should not be dispositive. It should be possible to rebut that presumption. But I think those serve as a prima facie evidence. For instance, if a group claims to be a church and has no congregation, no scheduled worship services participated in by a number of people, I think one can say it has not made a prima facie case, and therefore the IRS can proceed.

But if it does have some of those marks that everybody recognizes as the marks of an authentic religious body, then the burden of proof should shift to the Government to prove otherwise.

Senator **Grassley**. I think one last question, Mr. Gutman. You have heard people today say that there isn't a problem. And then you have heard the IRS say that they aren't sure exactly what the complaints against them are. In other words, we haven't defined the problem enough.

From your experience as a defender of religious liberty, is there a problem?

Mr. **Gutman**. Yes. And whether or not the problem can be quantified by statistics from the IRS, or from a private practitioner such as myself, or from Reverend Kelley's organization's records I think is irrelevant. Because in a case such as this, the perception of the problem becomes the problem.

If, indeed, the churches of America act under what they perceive to be the swooping down of the tax collector to examine their records, whether they are books of account or church records—and I think we still have to deal with that precisely—the perception of such a possibility inevitably creates a chill. And even if that perception is based upon an exaggeration, a paranoia, if you will, there is sufficient reality to create the reality of the chill, and therefore the problem is real. Therefore, it must be addressed. I think the Church Audit Procedures Act makes a step in that direction.

Mr. LEHRFELD. Mr. Chairman, since I have not been as constructive as the other members of the panel, I would like to make one constructive suggestion, if the Finance Committee is going to consider part or all of this bill. And that is an amendment to the declaratory judgment provisions which would authorize declaratory judgments where the church organization by law does not have a ruling and cannot gain access to a declaratory judgment review. It cannot do that today because there is nothing to revoke when a church dosen't have a private letter ruling.

Moreover, the present law could also be amended to take into account questions arising under the charitable contribution deduction provision which declaratory judgments do not now address. Because many times if you don't want to enlarge opportunities on exempt status when they translate into tax liability, there is no tax liability for a church because most church expenditures are of nonincome items, namely, contributions.

So the church itself which would control all of the litigation, if you will, about the right of deductibility is left out because the right to deductibility is by individual taxpayers who claims the deduction. The donor may not have the resources or the energy or anything else like that. So if you amend the declaratory judgment provisions to permit people without private letter rulings access, and No. 2, amend them to add matters relating to charitable contributions and thereby permit the organization most directly affected to declaratory review, I think you will enhance judicial review of administrative actions.

Senator GRASSLEY. All right. All the rest of my questions have been responded to. I want to thank you all for your testimony. And I would encourage you to keep in touch with us. And, hopefully, we will not forget that you are a tremendous resource as we look at this legislation further.

The meeting is adjourned.

[Whereupon, at 1:05 p.m., the hearing was concluded.]

[By direction of the chairman the following communications were made a part of the hearing record:]

ANNUITY BOARD OF THE SOUTHERN BAPTIST CONVENTION • 511 NORTH AKARD BUILDING • DALLAS, TEXAS 75201 (214) 747-9611

[illegible] 3:35

GARY S. NASH
General Counsel and Secretary of the Corporation

September 29, 1983

Senator Charles E. Grassley
Chairman, Subcommittee on IRS Oversight
135 Hart Senate Office Building
Washington, DC 20510

Re: Proposed Church Audit Procedures Act

Dear Senator Grassley:

This letter will confirm concerns I expressed on the telephone today to your aide Charles Jarvis concerning the proposed Church Audit Procedures Act. My concern is that, although the proposed bill does not purport to define the term "church" there may be some effort made to define and narrow the definition of the term "church".

To prevent this from happening, some care should be taken to assure that a broad concept of church is followed. In this regard, the present treasury regulations concerning "churches, the integrated auxiliaries, and conventions or associations of churches" should not be followed unless the exclusively religious test in those regulations is replaced by the following: "(c) whose principle activity is integrated with the religious purposes of the church, convention or association of churches with which the organization is affiliated." The legislation should thus make clear that the concept of "church" includes all organizations coming within this broad concept of church. For your information, enclosed is a copy of a letter dated September 14, 1982 to Vice President Bush signed by Dean M. Kelley, Secretary of the Coalition on Internal Revenue Definitions of Religious Bodies. That letter will amplify the concerns expressed in this letter to you.

To date, the Treasury and the IRS have shown a rigid insensitivity to the concerns expressed in the letter of September 14, 1983. While I would expect the IRS to continue its efforts to narrow the concept of the term "church", I would appeal to you to see that the concept of "church" is consistent with the request in the September 14, 1982 letter from the Coalition on Internal Revenue Definitions of Religious Bodies.

Very truly yours,

Gary S. Nash

Gary S. Nash

GSN/vm

cc: Dean Kelley

Enclosures

SERVING THOSE WHO SERVE THE LORD

COALITION ON INTERNAL REVENUE DEFINITIONS
OF RELIGIOUS BODIES

Dean M. Kelley
Secretary
100 Maryland Ave. N.E.
Washington, D. C. 20002
(212) 870-2783

September 14, 1982

Honorable George Bush
Vice-President of the United States
The White House
1600 Pennsylvania Avenue, N.W.
Washington, D.C. 20500

Re: Treasury Regulations Section 1.6033-2(g)(5)
--Integrated Auxiliaries of Churches

Dear Vice-President Bush:

The Coalition on Internal Revenue Definitions of Religious Bodies ("Coalition") is composed of people from different faiths, working together concerning the integrated auxiliary issue. An enclosure to this letter describes the membership of the Coalition.

Through this letter, we are requesting the Presidential Task Force on Regulatory Reform to assist us in urging the Department of the Treasury to amend the integrated auxiliary regulations promulgated under section 6033 of the Internal Revenue Code of 1954 ("Code") by utilizing a definitional approach which is consistent with Congressional intent. It is the Coalition's view that the addition of the term "integrated auxiliaries" to Code section 6033(a)(2)(A)(i) was meant to broaden the filing exception granted to churches and conventions or associations of churches, not contract it. We ask that you ensure that any new integrated auxiliary regulations be consistent with this intent.

THE REGULATIONS

Section 6033 of the Code requires certain tax exempt organizations to file an annual information return with the Internal Revenue Service ("Service") on Form 990, Return of Organization Exempt from Tax. Subsection (a)(2)(A)(i) of section 6033 exempts "churches, their integrated auxiliaries, and conventions or associations of churches" from this filing requirement.

On February 11, 1976, the Service issued a Notice of Proposed Rule Making concerning an amendment to the regulation promulgated under Code section 6033. The notice proposed the addition of a new subsection (g)(5) to Treasury Regulations section 1.6033-2, the purpose of the new subsection being to define the term "integrated auxiliary of a church." The notice drew intense opposition from those members of the religious community who were aware, or were made aware, of its issuance. About 100 letters were submitted in protest of the proposed integrated auxiliary definition. Many of these letters objected to a governmental effort to define a "church." Many of the letters also noted that the purported definition of "integrated auxiliaries" of churches narrowly and improperly characterized churches and church denominations so as to exclude many essential functions of churches and thereby distorted the meaning of "church" and "religion." However, on December 29, 1976, Treasury Regulations section 1.6033-2(g)(5) became final in substantially the same form as originally proposed.

THE REASONS THESE REGULATIONS SHOULD BE AMENDED

We believe the existing integrated auxiliary regulations offer a dramatic example of how government regulation can distract a useful and important segment of our society from most effectively performing its mission. For many years, the religious denominations of this country have defined and policed their own boundaries. Now, through the existing integrated auxiliary regulations, these denominations are being told that they really don't understand the term "church" and "convention or association of churches" even though their own polities and organizational documents had set the boundaries for those definitions long before the Service even existed. Suddenly, component organizations that have been squarely placed for decades in the middle of church denominational structures are in effect being told by the Service that they are not part of their church, and that they can only be integrated auxiliaries of their church if they are "exclusively religious." The latter phrase, narrowly restricted in the regulations to sacerdotal functions, does not appear in the legislative history surrounding Section 6033's enactment. We believe that the existing integrated auxiliary regulations are constitutionally defective and represent an unwarranted intrusion on the part of government into this country's religious community.

The Service is no longer only applying its reasoning in the abstract world of written regulations printed on a page. Although the Service has yet to allow any significant cases testing the integrated auxiliary regulations to be litigated in court, there now appear to be several cases pending litigation. The members of the Coalition are aware that the IRS enforcement of these regulations violates Congressional intent and Constitutional prohibitions.

Representatives of some church organizations have been told by the Service that they would not need to file Form 990 if the organizations were not separately incorporated, but instead operated as a division of the church in question. The existing integrated auxiliary regulations make this distinction, and we submit that this exaltation of form over substance should not stand when measured against the standards erected under our

Constitution's Establishment Clause. Religious denominations in this country function through a great variety of structural arrangements-- some hierarchical, some connectional, some congregational. That diversity makes the application of the regulatory test hopelessly impossible to administer on a rational and non-discriminatory basis.

THE RELIEF REQUESTED

We are urging the amendment of the existing integrated auxiliary regulations so that the new regulations (as amended) will be more consistent with the realities of twentieth century denominational church life. We urge that they must be reflective of the will of Congress in being expansive rather than contractive of the term church, convention or association of churches. The new regulations should eliminate a narrow sacerdotal definition of religion and "church"; eliminate specious formalistic tests based on whether a church entity is or is not separately incorporated; and recognize the diversity of structure of religious denominations in this country, including hierarchical, connectional and congregational. We also believe that any new regulations must in some manner reflect that component organizations that operate only within the bounds of a particular denomination must be recognized as exempt from filing Form 990.

We would urge that the present regulations be amended by deleting the present language of the regulation providing "(c) whose principal activity is exclusively religious" and substituting therefor the following:

> "(c) whose principal activity is integrated with the religious purposes of the church, convention or association of churches with which the organization is affiliated."

Therefore, there is no need for the definitional requirement found in (ii) of an exclusively religious purpose. Additionally, the present examples would be modified to conform to the approach taken by the revision proposed.

These changes would conform the regulations to the intent of Congress, meet the legitimate informational needs of the IRS, permit resolution or dismissal of pending court cases, and remove serious constitutional problems of religious freedom inherent in the present regulations.

Church leaders have had to expend the time, energy and resources required to cope with the burdensome integrated auxiliary regulations. We would prefer to channel our efforts and finances in a more productive direction, namely fulfilling churches' various religious missions. We and our technical advisors stand ready to be of assistance to you and the staff of the task force in whatever way we can.

Mr. Vice President, we ask your help in seeing that the existing integrated auxiliary regulations are amended. In light of impending litigation, we respectfully seek your assistance and a meeting with you on this issue by October 14, 1982.

Sincerely,

COALITION ON INTERNAL REVENUE
DEFINITIONS OF RELIGIOUS BODIES

By Dean M Kelley
Dean M. Kelley, Secretary

MEMBERS OF THE COALITION ON INTERNAL REVENUE DEFINITIONS OF RELIGIOUS BODIES

Dr. John Baker
Baptist Joint Committee
200 Maryland Avenue N.E.
Washington, D.C. 20002

Dr. Charles V. Bergstrum
Lutheran Council in the United
States of America
475 L'Enfant Plaza
Washington, D.C. 20024

Ray C. Dodds
Reorganized Church of Jesus Christ of
Latter Day Saints
World Headquarters: The Auditorium
Independence, MO 64051

Philip E. Draheim, Counsel
Lutheran Church-Missouri Synod
1633 Des Peres Suite 302
St. Louis, MO 63131

William S. Ellis
Lutheran Church in America
51 E 42nd Street
New York, NY 10017

Samuel E. Ericsson
Christian Legal Society
Box 1492
Springfield, VA 22151

Elwyn E. Ewald
Executive Secretary
Association of Evangelical Lutheran
Churches
12015 Manchester Road Suite 80LL
St. Louis, MO 63131

Hubert V. Forcier
Counsel
American Lutheran Church
1300 Northwestern Bank
Building
Minneapolis, MN 55402

Virgil Fuch
Lutheran Church-Missouri Synod
Secretary for Agencies and
Institutions
Board for Social Ministry Services
500 North Broadway
St. Louis, MO 63012

Jim Guenther
Executive Committee of the Southern
Baptist Convention
306 Nashville City Bank Building
Nashville, TN 37201

Frank Ingraham
Tennessee Baptist Childrens Home, Inc.
21st Floor Parkway Towers
Nashville, TN 37219

B. Edgar Johnson
General Secretary
Church of the Nazarene
6401 Paseo
Kansas City, MO 64131

Dean M. Kelley
Director for Religious and
Civil Liberty
National Council of Churches
475 Riverside Drive
New York, NY 10115

Bernard W. LeVander, Legal Counsel
Board of Pension of the Lutheran
Church in America
Board of Social Ministry of the
Minnesota Synod of the Lutheran
Church in America
720 Northstar Center
625 Marquette Avenue
Minneapolis, MN 55402

Eugene Linse
Lutheran Church Missouri Synod
Executive Director
Board for Social Ministry Services
4396 Hodgson Road
St. Paul, MN 55112

George W. McKeag
United Presbyterian Church
2100 Fidelity Building
Philadelphia, PA 19109

Forest Montgomery
Office of Public Affairs
National Association of Evangelicals
1430 K Street, NW Suite 900
Washington, DC 20005

Gary S. Nash
Annuity Board of the Southern Baptist
Convention
511 N. Akard
Dallas, TX 75201

Frank Patton, Jr.
Lutheran Church in America
51 East 42nd Street
New York, NY 10017

John T. Redmond, Counsel
United Church of Christ
1461 Franklin Avenue
Garden City, NY 11530

Robert A. Robinson
The Church Pension Fund
800 2nd Avenue
New York, NY 10017

David H. Rokke
Executive Secretary
Board of Trustees
American Luthern Church
422 S. 5th Street
Minneapolis, MN 55415

Gary M. Ross, Congressional Liaison
General Conference of Seventh-Day
Adventists
6840 Eastern Avenue NW
Washington, DC 20012

Rev. Dr. Robert C. Sallies
Vice President of Finance of Unitarian
Universalist Association
25 Beacon Street
Boston, MA 02108

Harold Stephens, Assistant General
Secretary
United Methodist Church
Board of Church & Society
100 Maryland Avenue N.E.
Washington, D.C. 20002

Dr. Kenneth L. Teegarden
General Minister and President
Christian Church (Disciples of Christ)
Box 1986
Indianapolis, IN 46206

Arnold L. Tiemeyer
Lutheran Church in America
Director, Special Services
Division for Missions in North America
231 Madison Avenue
New York, NY 10016

William P. Thompson
Stated Clerk of the General Assembly
United Presbyterian Church
475 Riverside Drive Room 1201
New York NY 10115

Earl Trent
House Counsel
National Ministry
American Baptist Church in the USA
Valley Forge, PA 19481

Mitchell A. Tyner
General Conference of Seventh
Day Adventists
6840 Eastern Avenue N.W.
Washington, D.C. 20012

Garrett C. Van De Riet
Christian Reformed Church in
North America
2850 Kalamazoo Avenue S.E.
Grand Rapids, MI 49508

Dr. Ewing T. Wayland
General Secretary
General Council on Finance and
Administration of the United
Methodist Church
1200 Davis Street
Evanston, IL 60201

THE CHURCH OF SCIENTOLOGY® INTERNATIONAL
West Coast Building, 118 N. Fort Harrison Ave., Clearwater, Florida 33515

STATEMENT OF REVEREND HEBER JENTZSCH
PRESIDENT, CHURCH OF SCIENTOLOGY INTERNATIONAL
REGARDING THE CHURCH AUDIT PROCEDURES ACT
S. 1262

Justice Oliver Wendell Holmes once stated that the power to tax is the power to destroy. Certainly, taxation has been used throughout history to oppress religions. The taxing power has been used to restrict, to limit, to inhibit -- and, yes, to destroy.

In the United States, a more religiously enlightened country, churches have Constitutionally been exempted from taxation by either the state or federal government. An agency of the United States, however, allegedly following the dictates of Congress, has arrogated to itself the power to decide, beyond any Constitutional power, whether any religious group is a church which qualifies for exemption. I speak, now, of the Internal Revenue Service.

IRS investigation of a religious group whose tax exempt status has been called into question can entail audits of virtually all of the group's activities, including details of the innermost workings of the group such as its ministers'

Church of Scientology International – a non-profit organization in the U.S.A., Registered in Florida.
Officers: President – Rev. Heber Jentzsch. Vice President – Rev. Rudy Loewing. Secretary – Sandy Brennen. Treasurer – Carol Cusworth.

sermons, the number of baptisms and ordinations, and the like. Should a church balk at releasing the information, the IRS can and frequently does rule that the church should be denied tax exemption, and a fortiori, its contributors denied deduction of contributions.

The IRS has abused its powers and created chaos by falsely asserting that Congress gave it the power to make such determinations. It has not hesitated to seek to destroy religious groups that question the propriety of its activities.

Why would the IRS seek to inhibit a Scientology Church which is opposed to drugs and has indeed created extensive anti-drug programs which are based on a technology of help?

Why would it seek to destroy the creation of good education using a new Scientology technology of education that allows a person to learn and retain knowledge at a far greater rate than any such system offered in the public school systems of today?

The religion of Scientology embraces the spirit, the field of logic, the belief, health and reason of the society.

The value of Scientology as a religious system and of individual Scientologists as productive members of the society is inestimable.

The Church of Scientology has not been timid when it comes to exposing excessive governmental abuse. And, of course, it has encountered difficulty with the Internal Revenue Service. In 1973, the Ninth Circuit noted, in Church of Scientology of Hawaii vs. United States, that the manual which IRS agents used contained "detailed instructions which purport to describe in part the religious philosophy of the Church [and which] appear to make [Scientology] organizations a suspect group." In 1975, in Handeland vs. Commissioner, the same court stated

> "We are disturbed by the length of time that the issue of the tax status of the Scientology Churches and ministers has been in controversy . . . any continued and unwarranted delay on the part of the government in reaching and resolving the merits of this class of tax suits, may suggest bad faith on its part and the prospect of awards for attorneys' fees and damages under the First Amendment."

Today -- eight years later -- the Internal Revenue Service is still entangled with the religion of the Church of Scientology, and a significant percentage of the church's revenues and ministers are employed simply to fend off IRS attacks -- revenues and ministers which could be used to help people in the ministry to the spirit of Man. The Church of Scientology, at this writing, has been more or less continuously engaged in defending itself from such entanglements for over 15 years.

Directly relevant to this Honorable Committee's determinations is the fact, well documented, that the Church of Scientology of California underwent an audit lasting more than a year and consisting of detailed perusal of some two to three million pages of documents. The audit requests were prejudiced and insatiable, inquiring in the most intimate detail into the polity of the church and its religious practices.

The Internal Revenue Service has allowed itself to be foolishly exploited by certain political figures in the past. The Founding Church of Scientology in Washington, D.C. wound up on the IRS "enemies" list. After public disclosure of the existence of this list, the church endeavored to determine the extent of IRS files on it. As of 1979, the Service had more than 102 linear feet of files on the church and the religion. Included were volumes of non-tax related records, including extensive files of internal church religious writings.

IRS pressure on the church caused a group of eleven Scientologists -- on their own, unknown to the church hierarchy -- to undertake a project to discover why the IRS would be attacking the church. These individuals, violating church policies, unfortunately resorted to illegally entering IRS offices in Washington, D.C. in order to copy agency documents regarding the church. (Since convicted of their crime, these persons are no longer in and forever banned from the employ of the church.)

Internal IRS files showed a pattern of attempting to suppress the religion's faithful, if not by tax laws, by "local statutes and ordinances available . . . to curtail or close down the operation." Other poison internal IRS memoranda in the sixties referred to the church as "philosophical voodooism," as "medical quackery or worse," and as a "pseudo-religion."

The agency had gone far out of its way to try to invent ways of showing that the Church of Scientology was not a church, and that Scientology was not a religion. Each issue found nonviable by the Service to deny tax exemption to the church simply engendered new and alternative issues to be used against it.

The Chief Counsel of the Internal Revenue Service at one point stated that "defining a church in regulations is one method to attack Scientology."

Surely it was not the intent of Congress that an agency of the United States government be given free rein to victimize and betray a religion. Surely it is not the intent of Congress to allow detailed perusal of all internal church religious documents in what is supposed to be a circumscribed audit.

While we have noted a more enlightened and conciliatory attitude in certain quarters of the IRS in recent times, we are concerned that there may be a revival of the antagonistic attitude of prior years, resulting in a renewed examination by the IRS into the underlying religious beliefs and ecclesiastical structure of the members and the church.

Commissioner Egger has testified that judgments by the Service regarding the nature of religious belief are both repugnant and unconstitutional. The church agrees, but has been the recipient of just such prejudiced judgments. When, we ask, did the IRS quit making such judgments?

The Church Audit Procedures Act is a vital and necessary act which will reinforce the traditional barriers to government incursions on religious liberty. The IRS has weakened and eroded these barriers, often without sufficient Congressional oversight. The act will give much needed protection to all churches, and all religions, and will be a welcome check on abusive and secret conduct by the Internal Revenue Service aimed at the destruction of religious freedom.

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